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"Looking at the Near Term Future of Lumber Markets" by Al Schuler

Competitive and dynamic lumber markets provide the insurance that the U.S. housing industry will continue to be supplied with the best building materials available including trusses, I-Joists, LVL, etc.

Historically, lumber markets are probably one of the best examples of nearly pure competition. That is, these markets have lots of buyers and sellers, minor barriers to entry (main one is wood supply), minimum government regulation/interference (except in recent years as described in the following paragraph), etc. Even with this, price usually reflects market conditions—too much lumber will yield weak pricing, while tight markets/strong demand such as today's environment, will give pricing a boost.

Figure 1 gives a twenty-year glimpse of the North American lumber market—how we got to where we are today. A dramatic shift in land use philosophy on federal lands in the late 80's led to a 30 to 40 percent reduction in softwood

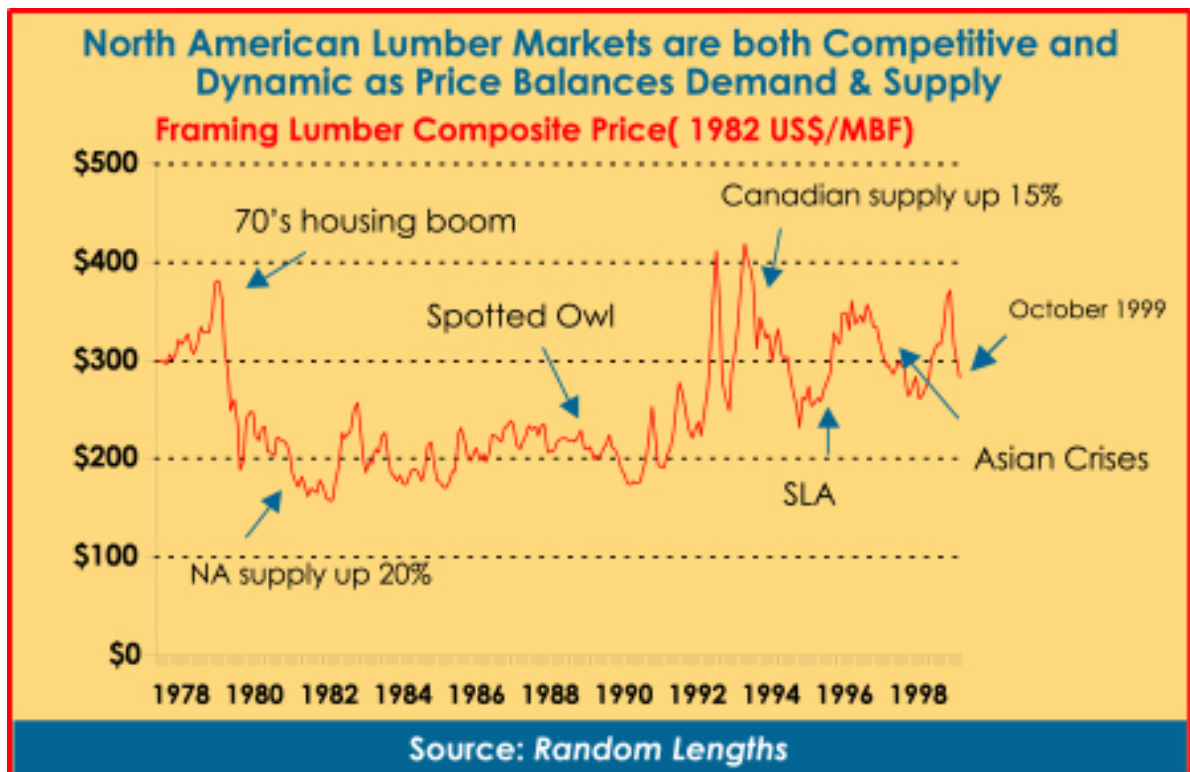


FIGURE 1

fiber availability in the Pacific Northwest ("Spotted Owl Crisis"). Loss of fiber forced stumpage rates up and many mills were forced to close while others moved capacity

Substitution is the real threat to lumber, however, as long as markets remain competitive and dynamic, wood building materials will remain the preferred choice of builders.

Construction materials in new homes

Material	1994	1997
Exterior walls		
Framing lumber	94%	84.7%
Concrete block	5%	13.5%
Steel framing		0.7%
Other	1%	1.1%
Interior walls		
Framing lumber	98%	92%
Steel framing	1%	7.6%
Other	1%	0.4%

Source: *Builder Magazine* May 1999

FIGURE 2

to the U.S. South. Higher stumpage rates in the Pacific Northwest drove North American lumber prices up (most species are substitutes) and this encouraged more production from Canada and the U.S. South. Canadian shipments eventually reached about 35% market share in the U.S., and this precipitated the Softwood Lumber Agreement (SLA), which effectively capped Canadian shipments. Unfortunately, the SLA was implemented when U.S. housing markets were heating up, and prices escalated. Then, the Japanese housing market collapsed in 1997, falling from 1.6 million (SAAR) in 1996 to about 1.2 million in 1997/98. So, prices fell again to balance supply and demand.

During this period of extreme price volatility, engineered wood products (I-joists and LVL) flourished and now make up about five percent of U.S. lumber consumption. In addition, offshore imports increased about 300 percent, albeit from a small base. In essence, the environmental policy shift acted as a shock to the market system adding about US\$75/M to cash costs for conventional lumber products. It has taken about 10 years for the market to adjust with new supply. In addition, the higher prices encouraged builders to search for ways to frame the house more efficiently, and this opened the door for roof and floor trusses, engineered garage door headers, panelized wall systems, manufactured housing, etc. Although the adjustment process is dynamic and will continue indefinitely, I believe the bulk of the current adjustment is complete. (Until the next shock—more harvesting restrictions in the South and eastern hardwoods? See Figure 2 on page 33.)

WHERE ARE WE HEADED?

Competition from domestic and offshore suppliers, engineered wood products, nonwood products, and more efficient building systems (e.g. trusses and heavier use of components) will prevent most building materials prices including lumber, from getting too far out of hand. Volatility will continue due to just-in-time delivery trends and a continuing shift to direct shipments (mill to

retailer or end user, often skipping wholesalers). Actual prices next year should be lower than 1999 because U.S. demand will fall with housing starts as the Fed cools the economy with higher interest rates. Offshore demand should be stronger, particularly for kiln-dried (KD) products in Japan as the Hanshin earthquake precipitated building code changes favoring KD and engineered wood products. However, U.S. and Canadian production capacity is currently at an all time high in response to strong pricing over the past few years.

THE BOTTOM LINE

Lumber markets will remain extremely competitive and dynamic, and prices will truly reflect demand/supply balance. Lower operating rates in 2000 will translate to lower prices—how much lower will depend on the degree to which U.S. housing cools. Finally, demand for labor and cost-saving building materials will only increase and that's good news for trusses, MSR, I-Joists, LVL and components.

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