OBSERVATION

TD Economics

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U.S. ANNOUNCES COUNTERVAILING DUTIES ON CANADIAN SOFTWOOD LUMBER

Highlights

- Yesterday, the U.S. Department of Commerce announced its intention to impose preliminary countervailing duties (CVD) on Canadian softwood lumber imports, with the measure being implemented retroactively for the past 90 days.
- Canada's economy is unlikely to be materially undermined by this policy initiative. However, in the U.S., the move will result in higher prices for wood products, feeding through to higher renovating costs and new home prices.

Yesterday, the U.S. Department of Commerce announced its intention to impose preliminary countervailing duties (CVD) on Canadian softwood lumber imports, with the measure being implemented retroactively for the past 90 days. At the root of the issue, the U.S. Commerce Department contends that Canadian producers receive unfair countervailable government subsidies related to the wood being harvested on public lands. The announcement came as a surprise, not in terms of softwood lumber being a key U.S. irritant, but in terms of the stance of the U.S. administration.

Overall, we do not believe Canada's economy will be materially undermined by this policy initiative. The pain will be disproportionately borne by British Columbia, but the outlook for provincial economic growth, expected to average 2.4% and 1.9% this year and next, should remain largely intact. As for the U.S., the move will result in higher prices for wood products, feeding through to higher renovating costs and new home prices. However, here too demand should remain strong enough to withstand rising costs, even as the more price-sensitive homebuyers may be squeezed out on the margin.

Not in new territory

The U.S. Commerce Department announcement was largely anticipated by the industry. Softwood lumber has been a key point of contention as far as trade between the two countries for decades. The 2006 Softwood Lumber Agreement (SLA) and the subsequent one-year standstill period expired in October 2016, with a new agreement yet to be reached. The five companies that were assessed will face specific tariffs, ranging from 3.02% to 24.12%, while a blanket average tariff of 19.88% will be applied to all other Canadian producers who export softwood lumber, siding, flooring and other coniferous wood products.

This decision is preliminary and must still be finalized by the U.S. Commerce Department and the U.S. International Trade Commission, which have to conclude that the American industry has suffered. This process is expected to be completed by September, however given this is the fifth time the U.S. has launched countervail duties on the industry in roughly 25 years, the decision will likely stand in some form. In addition, a preliminary decision regarding anti-dumping is expected in June, and could lead to additional tariffs on Canadian softwood lumber.

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Canada does not find itself in unknown territory. A similar situation occurred in 2002, following the expiration of the 1996 SLA. The U.S. Commerce Department implemented a 19% countervailing duty and an 8% dumping duty on Canadian softwood lumber. There were a number of challenges and court disputes that were eventually settled under the 2006 SLA, whereby the U.S. returned roughly eighty percent of the $5 billion in duties collected from Canadian producers.

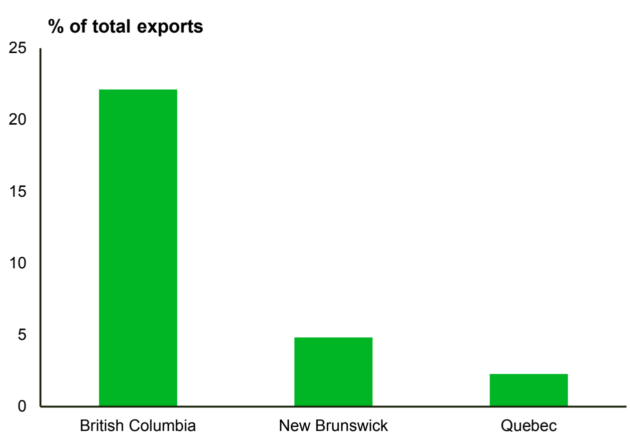
Under the 2006 SLA, tariffs were a function of the price, ranging between 5% and 15%, and kicking in when lumber fell below US$355 per thousand board feet. Some provinces opted to pay a lower tariff and adhere to export quotas, while others opted for no quotas but a higher tariff. Yesterday's near-20% tariff supersedes those prior initiatives and will apply regardless of the price of lumber.

Modest negative for Canada, concentrated in B.C.

The economic consequences will undoubtedly be negative for Canada, but not material enough to derail the economy. Lumber and wood products account for over 3% of Canadian international goods exports, with the U.S. tariffs applying to nearly half of these. The majority of Canadian lumber exports come from B.C., where the industry's exports to the U.S. account for 2% of economic output – more than quintuple the national share. The industry is also a significant contributor to the economies of New Brunswick and Quebec.

Some of the larger producers that have mills in the U.S. will be better able to withstand the countervailing tariffs. The same can be said for those that ship more lumber overseas, including those in B.C. that have recently diversified destinations of their shipments. On the other hand, smaller producers skewed to the U.S. market will be hit harder, with potential negative spillover effects in local economies dependent on lumber production.

CHART 1: LUMBER A MAJOR EXPORT FOR B.C.



Source: Industry Canada

The Canadian government has stated that it disagrees with the decision and will defend the interests of Canadian producers. Possible avenues include an appeal under NAFTA, the U.S. Court of International Trade or the WTO. In the past, Canada has been successful in arguing that lumber exports are *not* subsidized at the NAFTA tribunal. Still, even if successful, any dispute can take years to be resolved. Producers will likely have to pay the tariff throughout that period, and if Canada wins the appeal, be refunded the duties in the future.

Alternatively, Canada can also continue to work with the U.S. government in coming up with a new SLA that satisfies both parties. President Trump has also indicated his intent to renegotiate NAFTA, with a softwood lumber agreement likely part of these negotiations.

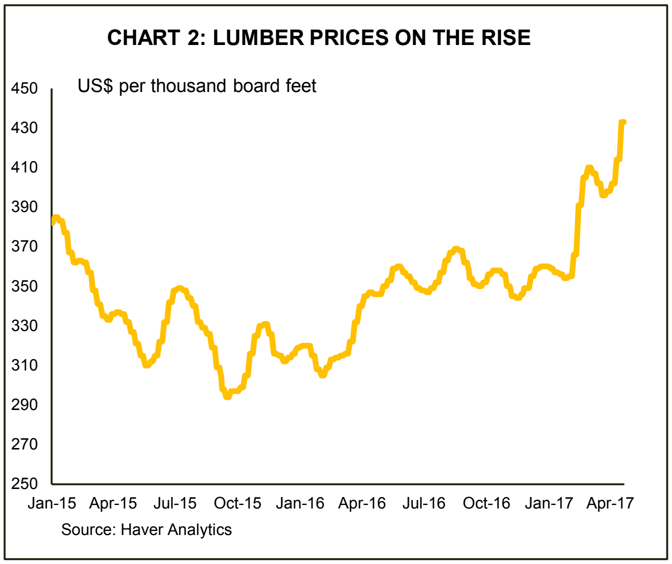
U.S. construction costs rise

The U.S. government was petitioned by American lumber producers to impose the CVDs, but support for such a move is not widespread. American homebuilders, who are among the largest consumers of Canadian softwood lumber, have voiced concern about the burden tariffs will place on American construction firms and consumers who will ultimately see a higher cost of new homes.

Canada supplies around 30% of the U.S. softwood lumber market, with homebuilding activity accounting for most of this consumption. Lower supply and/or higher prices for Canadian lumber would hit American consumers with higher price tags for new homes – which have already risen 40% in the past five years and remain more than 10% above their previous peak.

The U.S. National Association of Home Builders (NAHB) has estimated that lumber accounts for about 7% of new home construction. With tariffs expected to raise the price for softwood by over 6%, this would add over $1,200 to the cost of a new home. In addition, lower construction activity may put pressure on jobs in construction, transport, and retail industries which are not expected to be offset by any additional hiring within the highly capital-intensive lumber manufacturing industry.

While any impacts are likely to be modest relative to the size of the U.S. economy, they are not necessarily immaterial. The housing market is already contending with



low homeownership, rising mortgage rates and escalating prices due to supply constraints. Overall, we expect two main outcomes: 1) price increases will get passed on to the consumer, as has been evidenced with past tariff initiatives against Canada and other countries and 2) the second-order impacts are net negative to supplier chains and related jobs/incomes. But, the softwood lumber tariffs are more about politics than economics, and this is the true threat that will linger on Canada as the new administration follows through with political promises.

Bottom Line

In large part, commodity markets were anticipating this policy move. Lumber costs had already moved 25% higher since the election to a 4-year high. This coupled with a softening in the Canadian dollar will help cushion the blow to Canadian producers, but not prevent it. Likewise, U.S. demand fundamentals remain sound. So while the U.S. construction industry may see modestly lower activity, higher input costs are unlikely to derail housing starts from their gradual upward trek. This should help place a floor under Canadian lumber exports.

Despite this tariff on softwood lumber being preliminary, it represents a strong signal that President Trump is out to make good on his campaign promise to ensure better trade conditions for America. Canada's dairy and energy sectors have also came under scrutiny recently, and yesterday's announcement may be a sign of more to come.