



**HIGHLIGHTS**

- Lumber prices shot up by 50% during the first four months of the year, before giving up those gains entirely over the past two months.
- The initial surge in prices came as supply fell short of demand due to earlier production curtailments and log shortages.
- The subsequent fall in prices stemmed from a delayed bounce back in output, while demand began to moderate after peaking in April.
- Going forward, prices will likely get a seasonal bounce in the third quarter, before losing some ground towards the end of the year. In 2011, we expect prices to gradually rise, reaching US\$340 by year-end.

**WHAT'S NEXT FOR LUMBER PRICES?**

Lumber prices have had quite the ride this year, surging by nearly 50% during the first four months of the year, before giving up all of those gains within the last two months. Indeed, prices, as measured by the Random Lengths Framing Lumber Composite, hit a 4-year high of US\$367 at the start of May, and plunged by over 30% to US\$247 in early July. This wild ride has left the market wondering what was behind the sharp turn around, and what is in store for lumber prices going forward.

**The run up**

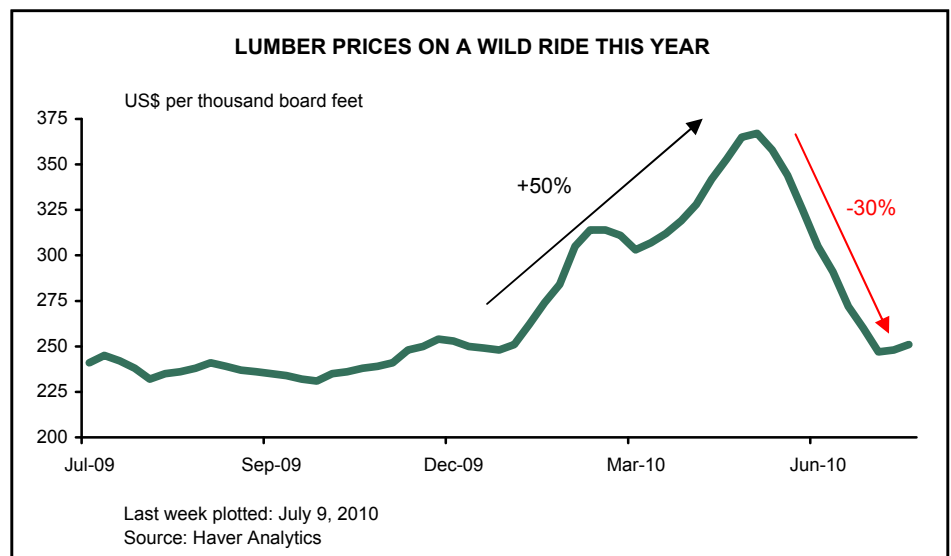
The rapid rise in lumber prices seen early in the year was mainly a supply-side story. North American producers had been slashing production so much throughout 2009 that output was at or below final demand levels. Meanwhile, stockpiles were drawn down dramatically, leaving inadequate inventory in the supply chain to meet any uptick in demand. So at the start of this year when year-over-year demand did turn positive, as the U.S. housing market began to show some signs of life and buyers began to restock inventory, production fell short of consumption. Furthermore, offshore demand picked up – particularly from China where the economy was charging ahead at full steam – putting an even bigger strain on output. While producers were indeed working to ramp up supply, there is a time lag for production restarts in the lumber industry, limiting the rate at which supply could increase. Making matters worse, excessive rain early in the year in some producing regions led to log shortages, which squeezed the market even more. As a result, prices shot up dramatically, overshooting these tight market fundamentals.

**The plunge**

After a surge in prices of that speed and magnitude, it is not entirely surprising to see a correction. However, this correction is larger than most were anticipating. What led to the sharp drop in prices over the past two months?

Again, the supply side has played a large role. The lagged response of producers

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to the rally in prices came into play in April, with output rising throughout the second quarter. We had cautioned in our earlier forecasts that if producers get overanxious and lack the discipline needed to keep the market balanced, higher prices will be hard to achieve. And in May and June, production was easily outpacing demand, bringing the market back into a position of excess supply. Canadian producers in particular increased output as they enjoyed a tariff-free month in June (thanks to the higher prices earlier this year, as governed by the Softwood Lumber Agreement). This drove exports to the U.S. up 21% on the month.

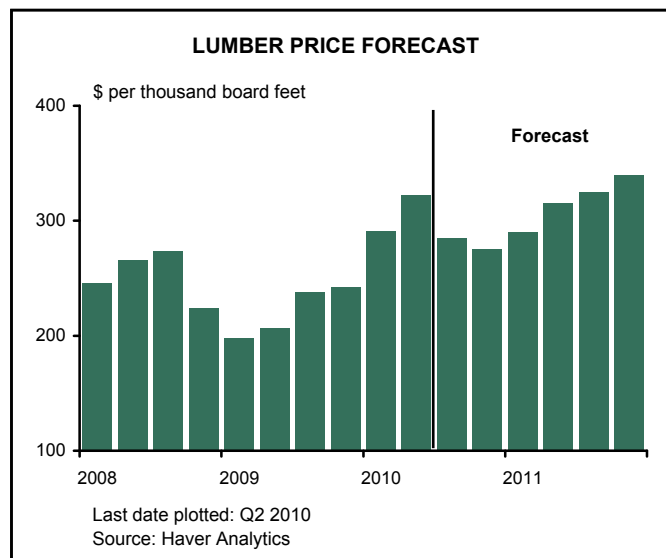
But the demand side of the equation has also helped drive prices down, with new orders peaking in April before sliding in May and June. Given that the U.S. housing market accounts for roughly half of total lumber demand in the country, much of the recent weakness can be attributed to the expiration of the homebuyer's tax credit stateside. This is evidenced by the fact that U.S. housing starts reached a 17-month high of 659,000 units in April before plummeting below 600,000 in June, for the first time this year. And with other economic indicators in the U.S. showing signs of slowing, lumber buyers have shied away from the market.

**Where to from here?**

So after such a wild ride, what is in store for prices going forward? Weaker demand when prices are falling sharply does not come as a surprise, as buyers purchase only enough material to cover their immediate needs in order to ensure that they don't lose out on lower prices down the road. But the downtrend appears to have come to a halt over the past two weeks, with prices stabilizing around the US\$250 level. Nonetheless, the fundamental picture does not suggest that prices will return to their recent highs anytime soon.

Indeed, the outlook for demand is not too bright in the near term. The U.S. housing market has a long road ahead, and there will be many bumps along the way. Even once the hangover from the homebuyer's tax credit subsides, the new home market will be facing a great deal of competition from the existing home market, as foreclosed properties are still on the rise. As well, the labour market is recovering slowly and won't likely recoup all the jobs lost before the end of next year, making it difficult for potential buyers to access the credit needed to purchase a home. As a result, we expect housing starts in the U.S. to remain close to current levels over the next couple of months before gradually creeping up towards the 1 million unit mark by the end of next year.

Demand from Canada isn't likely to provide much offset, as we expect the housing market to cool significantly in



the coming months after growing at an unsustainable pace over the past year. We project housing starts to hover in the 165,000-170,000 range through the end of 2011 – a marked decline from the 200,000 unit rate seen earlier this year. Offshore demand will also offer little help, as economic growth in several countries around the world – including China – will also likely moderate in the coming months.

Still, seasonality is likely to kick in during the third quarter as usual. And with inventories on the low side, another round of buying is likely to give prices a modest boost from current levels during the July-September period. Thereafter, however, demand is likely to remain subdued, suggesting that prices will be heavily influenced by any changes in supply. Already, producers have announced production curtailments in response to the plunge in prices which should help mitigate further losses. The lower prices will bring the tariffs on Canadian exports back to the maximum by September, so producers north of the border will likely cut output even more.

As long as producers don't get too excited about the seasonal bounce in prices and are disciplined enough to keep output in line with demand, prices – which may lose some steam following the seasonal uptick – are not likely to fall below current levels. Next year, as demand begins to slowly rise, prices should follow suit. Of course there is the risk that prices will give the market an encore performance of the swings seen during the first half of this year. However, we suspect that producers will be more careful next time around, keeping supply in check. As such, we have downgraded our lumber price forecast to include some weakness over the balance of this year, before gradually trending up to US\$340 by the end of 2011.



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