TD Bank Financial Group

TD Economics

Special Report

September 8, 2009

LUMBER MARKET POISED FOR RECOVERY

While the current recession has taken a toll on most industries in Canada, it has exacerbated the troubles that have been plaguing the lumber industry since 2006. This year, both prices, on an inflation-adjusted basis, and production levels have fallen below the lows seen during the recession of the early 90's. But following several months of supply outpacing demand, the lumber market has finally begun to tighten, inventories have fallen to their lowest level in over 5 years and producers are now able to have more of an influence on prices. And after trading within the US$195-215 range for seven months, prices (as measured by the Random Lengths Framing Composite) finally turned the corner in June, hitting a 9-month high of US$245 in early July. But even with the improvement in fundamentals, the lumber market still has a bumpy road ahead, with prices not expected to return to the long-term average of about US$400 until 2011.

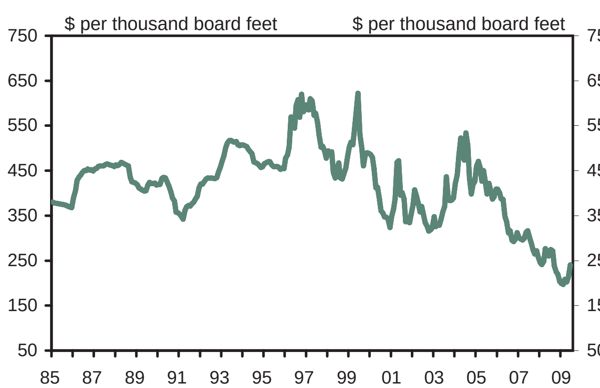
HIGHLIGHTS

- **Lumber prices have begun to turn the corner, but remain far off historical norms.**
- **Demand is on track to hit its lowest level since the early 1980s; however, consumption should pick up next year as the housing market in both the U.S. and Canada continues to improve and other end-use markets pick up steam alongside the economic recovery.**
- **Ongoing production curtailments have improved the supply-demand balance, but with utilization rates hovering around 50%, further capacity closures are likely to take place through 2010.**
- **Canadian producers are facing additional headwinds, including an elevated loonie and a tax on exports destined for the U.S.**
- **We expect prices to rise gradually in 2010, but not to return to their long-term average of about US$400 until 2011.**

Structure of the North American lumber market

Lumber production in North America is fairly evenly split between the U.S. and Canada – with Canada accounting for over 45% of overall output – suggesting that suppliers in both countries can have a significant influence on prices. On the consumption side, the U.S. is the dominant market, accounting for about 75% of total consumption, and is therefore a very important market for Canadian producers. Indeed, about half of Canadian softwood lumber is exported to the U.S., accounting for more than a quarter of lumber supplied south of the border. Offshore exports make up about 15% of Canadian production, with the domestic market consuming the rest.

U.S. LUMBER PRICES
(2008 dollars)



Last month plotted: August, 2009
Source: Haver Analytics

Housing market weakness weighs on lumber demand

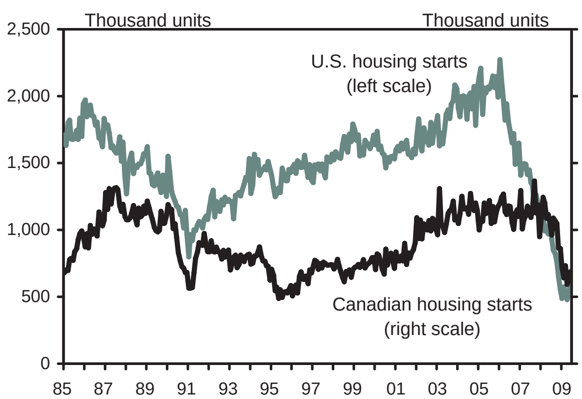
Lumber consumption in North America peaked in 2005, and has fallen steadily ever since. This year, demand is on track to hit its lowest level since the early 1980s, with the largest declines occurring south of the border.

With home construction accounting for nearly half of all U.S. lumber consumption, the housing market stateside is an important indicator for lumber demand. In fact, the relationship between U.S. housing starts and lumber prices has been quite strong, particularly over the past 5 years. Unfortunately for lumber producers, during the first half of 2009, housing starts in the U.S. had sunk to 50-year lows, and less than a third of the 10-year average. Nonetheless, we are encouraged by the fact that new home construction appears to have bottomed out, with starts in June and July hovering at their highest level since last November. Still, at a current rate of 580,000 units, new home starts will be slow to climb back to the demographic driven rate of about 1.4 million units per year.

Supporting the recent uptick in housing starts, new home sales have begun to show some signs of life – rising 5% in the second quarter, and a further 9.6% M/M in July – bringing inventories of unsold homes down from 12.4 months supply in January to 7.5 months supply in July. And with credit conditions having eased at such a rapid rate, and with historically low mortgage rates, demand for new homes is likely to strengthen. Still, sales are sitting at their lowest level since the recession of the mid-1980s, providing more evidence that it will take time for new homebuilding activity to return to pre-recession levels.

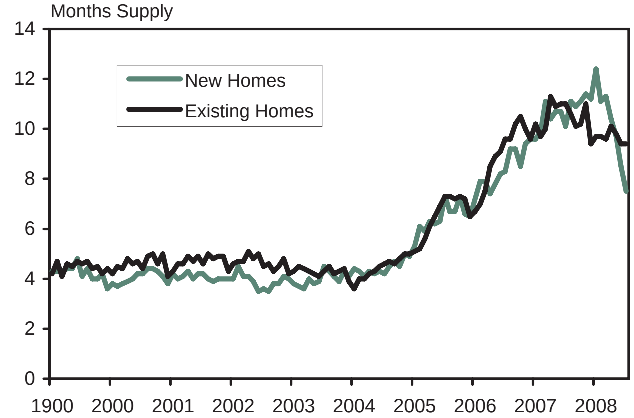
But, while the housing market appears to have stabilized, there are some downside pressures, which, at the very least, will temper the recovery. First off, even though job

HOUSING STARTS IN CANADA AND U.S.
(seasonally adjusted annual rate)



Last month plotted: July, 2009
Source: Haver Analytics

U.S. EXISTING & NEW HOME MONTHS SUPPLY

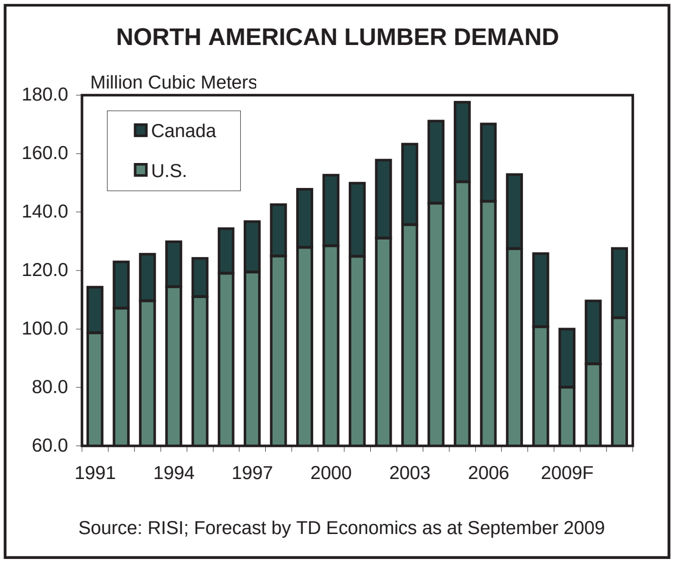


Last date plotted: July 2009
Source: National Association of Realtors. Census Bureau

losses are softening, the labour market remains extremely weak, with employment and wages falling, and the unemployment rate expected to hit over 10% in early-2010. Moreover, mortgage rates, which have already begun to creep up, will likely continue to rise, which will depress affordability. Furthermore, existing homes are providing some hefty competition for homebuilders as foreclosures are still on the rise. Indeed, despite an uptick in existing home sales in the second quarter, the inventory of unsold homes has not dropped as much as in the new housing market. Lastly, the First-time Home Buyer Tax Credit, which is equal to 10% up to a maximum of US$8,000 of the purchase price, expires on December 1st, 2009, which may temper the growth in sales thereafter.

While the U.S. housing sector appears to be on its way to recovery, these factors will keep housing starts at historically low levels throughout this year and next. Indeed, we only expect starts to reach 750,000 units – about half the rate of household formation – by the end of this year. In 2010, starts will continue to trend upward, but won't likely break through the 1 million unit mark, on a sustained basis, until 2011.

In Canada, the correction in the housing market was not as severe as in the U.S., but housing starts still hit a 13-year low of 120,000 units in April. Since then, starts have shown some improvement, but like in the U.S., remain well below historical standards. We expect housing starts in Canada to average below 160,000 units in 2009 and 2010 – levels not seen since early in the decade. At best, new home building could creep back up to the demographic driven rate of 175,000 units by the end of 2011; however,



we don't expect them to reach pre-recession levels of over 200,000 units anytime soon.

Other end-use markets aren't much healthier

While homebuilding activity has weighed heavily on lumber demand, other end-use markets have failed to provide any offset. U.S. residential improvement expenditures have been sliding along with employment and household wealth, and are likely to remain weak until after an economic recovery is well entrenched. Meanwhile, nonresidential construction expenditures, after holding up relatively well in 2008, plunged by over 40% in the U.S. in the first quarter of 2009, and by a more modest 14% in Canada. Investment in this sector typically lags the economic cycle, as there is usually excess capacity following a recession that must be worked down and businesses delay investment until a recovery in demand is certain. Hence, any uptick in lumber demand from this sector won't likely happen before the second half of 2010.

Elsewhere, industrial production in the U.S. has suffered a significant drop due to economic conditions and the resulting drawdown of inventories. A large chunk of the decline was due to the massive reduction in auto output, which doesn't use much wood. Still, other sectors that do, such as furniture production, have been hammered as well – down 23% Y/Y as of June. And given that the U.S. market is a key consumer of Canadian-made furniture, production north of the border plunged 42% as of April. On a brighter note, this sector is likely to recover alongside the economy, hence positive growth by the end of the year is in the cards.

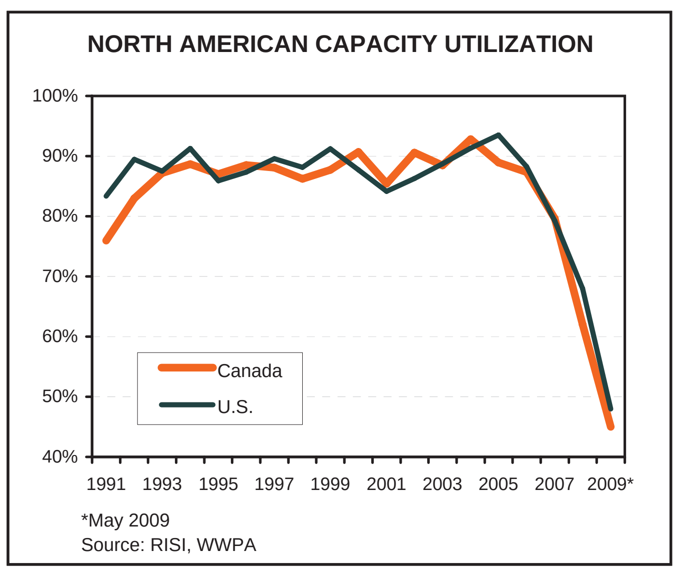
Offshore exports providing little offset

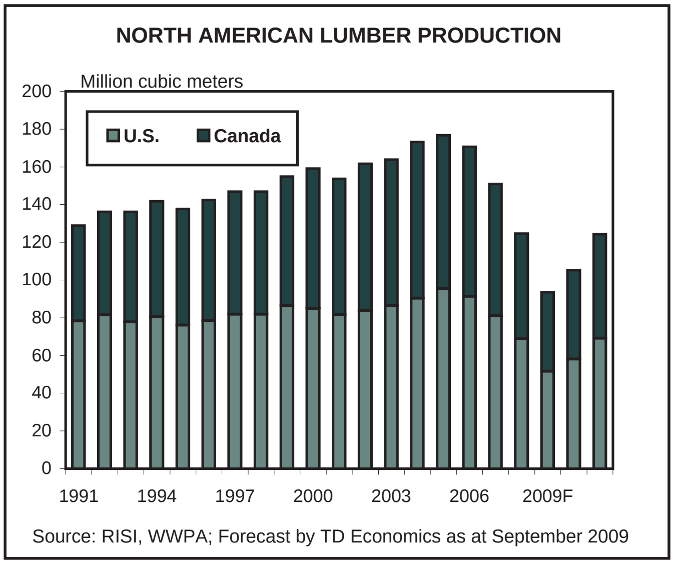
With North American demand quite depressed, producers have found some support in foreign markets. Higher timber costs in offshore markets and low domestic prices have helped exports remain buoyant, although consumption in these markets has also slowed over the past few months. China in particular has increased its lumber imports from Canada (+ 45%) and the U.S. (+ 31%) during the first half of this year, as low prices have provided an affordable alternative to Russian imports which have been disrupted by the recession recently. Still, export markets other than the U.S. account for only a small portion of total Canadian sales.

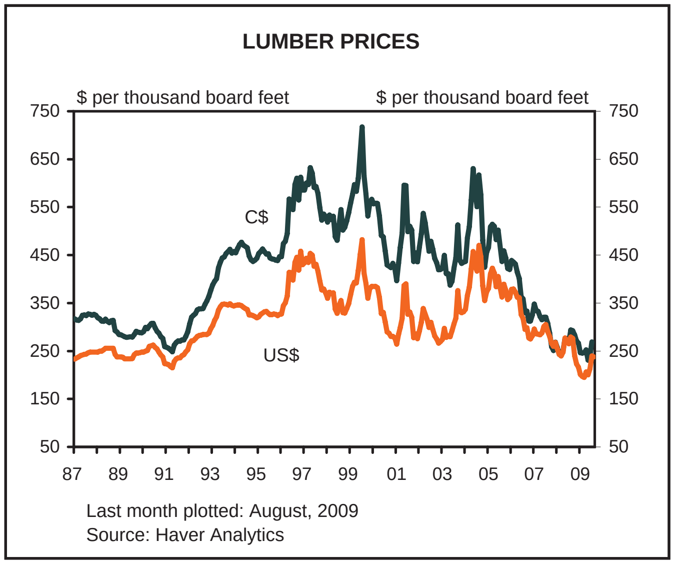
Overall, demand for lumber should begin to turn a corner later this year as housing starts in the U.S and Canada improve and consumption in other end-use markets gains momentum alongside an economic recovery. After contracting by around 20% in 2009, North American lumber consumption should bounce back by about 10% in 2010, led by the U.S. market. In 2011, we expect demand to grow by a further 15%, moving more in line with the average consumption rates seen prior to the start of the boom years in 2002.

North American inventories slimming down

Once demand does show evidence of a sustained improvement – likely in 2010 – producers will be well positioned to increase output. First off, the 28% drop in North American production during the first five months of this year has driven inventories in both countries to the leanest levels in over 5 years. Moreover, these massive production curtailments pushed the capacity utilization







rate in both countries below 50%, leaving a large chunk of capacity sitting idle. While additional mills are likely to succumb to market pressures and shut down – with closures continuing to take place through 2010 – there should still be plenty of room to ramp up production as demand gradually comes back. Overall, we expect to see total lumber output in North America hit bottom this year, before rising 10-15% in 2010 and a further 15-20% in 2011. While the relative output performances in Canada and the U.S. have been about par so far this year, U.S. producers will outperform as the recovery gets underway as producers north of the border face a handful of challenges aside from dwindling demand.

Several headwinds facing Canadian producers

Chief among them is the rise of the Canadian dollar, which increased from below 80 US cents in March to over 90 US cents in July and August. Indeed, the rise in the loonie has undermined much of the recent uptrend in prices for Canadian producers. Between March and July, prices jumped 23% in U.S. dollars, while rebounding by only 9% in Canadian dollar terms. And given that we expect the loonie to lose some ground by the second half of next year – falling to 87 US cents by the end of 2010 – Canadian production is likely to rebound more forcefully towards the end of the year.

Chipping away at profits for Canadian producers even more is the export tax on lumber sent to the U.S. as a result of the Softwood Lumber Agreement (SLA). For B.C. and Alberta, the tax rate increases as prices fall. Currently, these provinces are paying 15% on lumber exports to the U.S. Quebec, Manitoba, Ontario and Saskatchewan are also currently being charged a total of 15% due to an earlier violation of the agreement. Maritime provinces are exempt from the SLA. See the accompanying text box for an update on the SLA.

Softwood Lumber Agreement

The U.S. has filed two separate claims against Canada with respect to the Softwood Lumber Agreement that came into effect in October of 2006. In February, the London Court of International Arbitration (LCIA) came down with its ruling on the first case, finding that sawmills in Quebec, Manitoba, Ontario and Saskatchewan were in violation of the SLA for the first half of 2007 and required them to pay an extra 10% export tax (in addition to the 5% already in place) on lumber sold to the U.S. until C$68.26 million has been paid. As an alternative, the Canadian government offered to pay the U.S. government C$46.7 million, but the offer was declined, and the U.S. implemented a 10% duty, effective April 15th, 2009. Canada has since disputed this duty and is awaiting clarification from the LCIA. (B.C. and Alberta chose the other option, and are paying a 15% export tax.)

In the second case, the U.S. has claimed that aid packages provided for the Ontario and Quebec lumber sectors are in violation of the SLA. The LCIA has yet to rule on the case, but a decision is expected towards the end of this year.

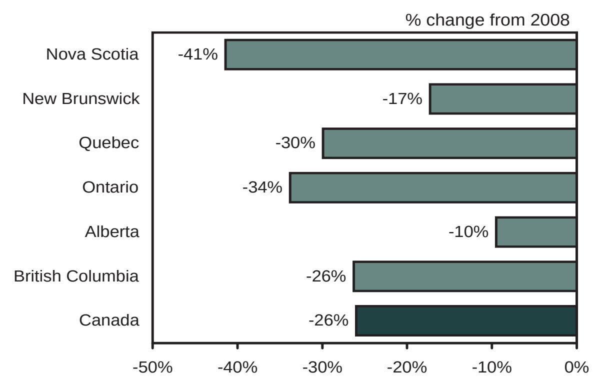
Source: Random Lengths, Vol. 65, Issue 29, July 17, 2009.

Provincial Breakdown

Within Canada, provinces east of the Rockies experienced the largest reductions in capacity last year due to higher production costs, while B.C. saw less attrition, partially owing to high shutdown costs. But with lumber prices hitting record lows this year, capacity destruction in B.C. has begun to catch up. Still, during the first five months of the year, capacity utilization rates in B.C., at 47%, remained slightly higher than that in provinces east of the Rockies (43%). Nonetheless, in terms of volume, B.C. has scaled back output the most – which comes as no surprise given that the province accounts for half of all lumber produced in Canada.

In percentage terms, Nova Scotia has been hit hardest so far this year, though the province only produces 1% of total Canadian output. Ontario and Quebec, with a more significant share of production at 10% and 22%, respectively, have also been forced to slash output dramatically this year, while Alberta (13% share) has managed to outperform. See the accompanying chart for details.

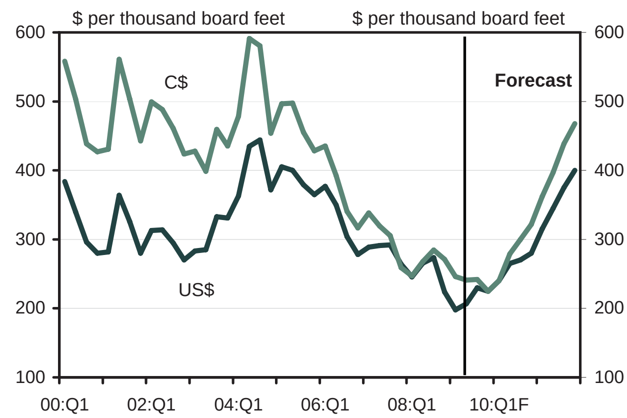
2009* LUMBER PRODUCTION BY PROVINCE



*YTD as of June
Source: Statistics Canada

In B.C., several labour contracts expired at the end of June, with no new agreement as of yet. With lumber prices sitting at historical lows, producers will be looking to reduce labour costs, which will likely be a difficult task when dealing with unions. Also in B.C., fire season is currently underway, and extreme heat in the province has already sparked some intense forest fires. Making matters worse, forested areas that have been attacked by Mountain Pine Beetles have left the wood very brittle, thus increasing the risk of fires. And with supplies on the tighter side now, any unwanted production curtailments due to either actual or the threat of forest fires could have significant implications for prices.

LUMBER PRICE FORECAST



Last date plotted: Q2 2009
Source: Haver Analytics

Prices to hit US$400 in 2011

Putting it all together, an improvement in the supply-demand balance will set the stage for a sustained recovery in lumber prices. In 2010, a steady uptick in consumption will drive operating rates up, providing support for a price rally. But with so much excess capacity sitting on the sidelines, as prices rise, producers will be tempted to boost production in order to rake in higher profits, thereby limiting the upside potential. With the rise in Canadian output likely to trail that in the U.S., prices should see a steeper rise during the first half of 2010. Overall, we expect seasonal factors to cause prices to dip slightly in the fourth quarter, to an average of US$225, before rising to US$280 by the end of 2010. While definitely an improvement, prices will still be low compared to historical standards, with this bounce back only bringing prices back to 2007 levels.

The full recovery – when prices return to historical norms – will come in 2011 and beyond. As demand picks up steam, producers will be bumping up against full capacity, as the shutdowns seen through 2010 will be slow to come back. With inventories still on the tighter side and production unable to keep pace, prices will be poised for a sharp rebound, finally revisiting the long term average of US$400 in 2011. What's more, capacity in Canada will become more limited down the road, as the Mountain Pine Beetle infestation is expected to consume about 80% of B.C.'s pine forests by 2013. All of this spells good news for prices in the medium-to-longer term.

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