OBSERVATION

TD Economics

June 12, 2013

LUMBER PRICE CORRECTION WILL NOT LAST

Highlights

- After reaching a 9½-year high in mid-April, North American lumber prices have since tumbled by 25%.
- The sharp drop has been driven by a combination of rising production and slumping demand both at home and abroad, in addition to traditional seasonal factors.
- Despite the recent declines, the outlook for lumber prices remains bright. Demand in the U.S. should pick up alongside rising housing starts, while exports to China are also expected to bounce back.
- Overall, lumber prices are forecast to rise by 30% between now and the end of 2014.

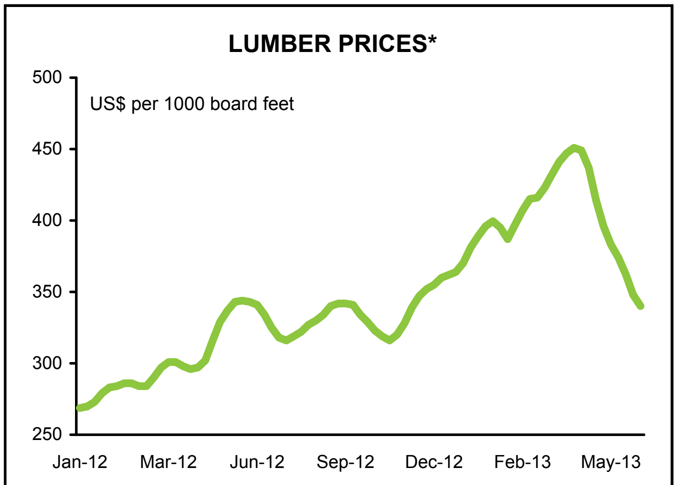
While several commodities have been in the spotlight in recent months, lumber has not been one of them. However, some light should be cast on the market given that prices have been tumbling quite rapidly over the past nine weeks. Indeed, after reaching a 9½-year high in mid-April, lumber prices, as measured by the Random Lengths Framing Lumber Composite, have since been in freefall. Prices are now down 25% from their April peak, erasing most of the 40% gain accumulated during the six months prior.

Looser market fundamentals taking steam out of prices

The sharp drop in lumber prices seen over the past two months has been largely due to market-specific fundamentals, in contrast to the global and macroeconomic-induced decline seen in industrial commodity prices.

To recall, lumber prices were hit pretty hard during the recession, as the U.S. housing market tanked, taking a significant chunk of lumber demand down with it. As a result, some consolidation took place among sawmills, in order to bring production more in line with demand.

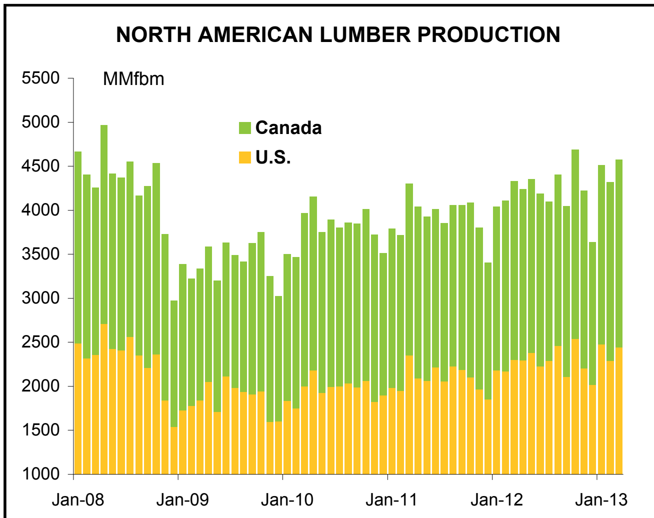
The recent resurgence in the American housing market – with new home starts now nearly double what they were during the recession – had fueled a similar revival in lumber demand, with shipments from Canada to the U.S. up 16% y/y during the first quarter. Meanwhile, offshore demand, particularly from China, was on the rise, with China now accounting for over 6% of North American shipments – up from under 1% prior to 2008. At the same time, inventory restocking had been taking place, adding even more demand. With producers struggling to meet buyer needs, prices shot up sharply.



*Random Lengths Framing Lumber Composite
Source: Haver Analytics

Dina Ignjatovic, Economist, 416-982-2555

Source: Forest Economics Advisors, International Wood Markets Group, TD Securities



Source: Random Lengths, Forest Economic Advisors, TD Securities

North American producers have since responded by increasing output, allowing them to meet demand more easily. Indeed, production was up by 7% y/y in the first quarter of 2013, following an 11% y/y jump in the final quarter of last year.

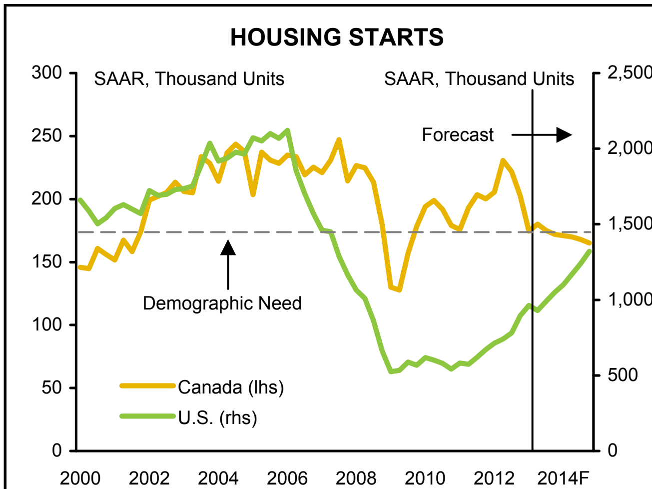
However, as production and prices have risen, demand has moved in the opposite direction. Adverse weather conditions in the U.S. during the spring months delayed several projects and were perhaps at least partially responsible for the drop in single-family housing starts – which account for most of new housing-related lumber demand – in March and April. While a much smaller market, housing construction in Canada has been trending down since April of last year, providing no offset. Meanwhile, high North American prices drove China to look for alternative sources of lumber, which combined with elevated inventories, dampened offshore demand.

The combination of increased output and weaker demand, as well as the traditional seasonal factors, has taken some steam out of the lumber price run over the past two months. What's more, since prices began to fall, adequate inventories have allowed buyers to wait on the sidelines to see how low prices will go before jumping back into the market, exacerbating the downward spiral.

Where to from here?

Despite recent trends, the outlook for the lumber market remains bright. While the price decline has been sharper than anticipated, we had initially forecasted a weaker second quarter due to seasonal factors and the expectation of higher production. As such, our overall outlook remains largely intact.

Demand for lumber is likely to spring back in the coming months, particularly in the United States. The housing market south of the border is expected to continue to gain traction, with new home starts reaching a seasonally adjusted annualized rate of 1.3 million units by the end of 2014. In particular, single unit starts are forecast to rise to over 900,000 units over the next 18 months – up 50% from that recorded in the first quarter of this year and the highest level seen since 2007. What's more, this pace of homebuilding activity is still below demographic fundamentals – 40% in the case of the single-family market – suggesting that the U.S. housing market will continue to be a key support for lumber demand and prices going forward.



Source: Haver Analytics; Forecast by TD Economics as at June 2013

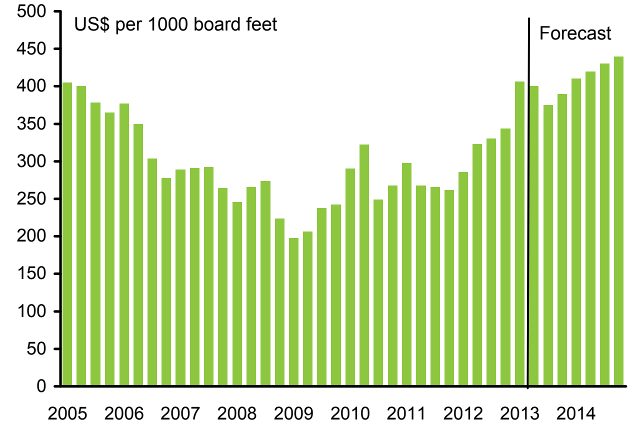
Similarly, demand in China is expected to bounce back, as inventories are worked down and construction activity picks up in the second half of this year and in 2014.

This bodes well for Canadian producers since these two countries account for roughly 65% of total shipments. Canada has actually become China's largest supplier for lumber, accounting for roughly a third of total imports in 2012. Moreover, our outlook for the Canadian dollar, which we expect to slide to the 90-95 US cent range over the next 3-4 quarters, will also be a welcome development for producers – particularly since the picture in Canada is less rosy.

Indeed, notwithstanding the jump in May, the downtrend in Canadian housing starts is likely to continue, bringing them more in line with the rate of household formation. In fact, given the overbuilding that has occurred over the past ten years, there is a risk that starts will even fall slightly below the demographic need for a period of time. While renovation activity may provide some offset, new home-building activity in Canada is unlikely to provide much support for lumber prices over the forecast horizon.

Weather pending, we should also see a seasonal uptick in demand for lumber in the coming weeks, which should help put a floor under prices. Moreover, while production is on the rise, little capacity has been added, which has driven up operating rates. In 2012, operating rates jumped to over 70% – a much higher rate than the 56% recorded in 2009. This trend is expected to continue, implying a tighter market over the next couple of years, which certainly bodes well for prices.

LUMBER PRICE* FORECAST



*Random Lengths Framing Lumber Composite
Source: Haver Analytics, Forecast by TD Economics as at June 2013.

Bottom Line

All told, we forecast lumber prices to bottom in June, before resuming an upward trend throughout the remainder of our forecast period as the market tightens. From current levels, we expect prices to record a 30% gain by the end of next year.

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