



January Lumber Market Analysis

By Zara Heartwood and Kéta Kosman

March 4, 2011

OVERVIEW

Traders caution that customers could not be strong-armed into placing their orders.

"Convincing buyers that now is the time to strike is still a challenge," said one trader.

Conservative players are always behind the curl of the demand wave. The checkered flag has been waved but the gentlemen are still sitting in the pits, wondering if it's time to start their engines.

As much of WSPF is turning to the Pacific rim for sales, North America may find ESPF looking more attractive in 2011.

- **No one buys when weather forecasts turmoil.**
- **Don't let the futures board dictate your actions**
- **The bears slept while the bulls sharpened their horns.**
- **Watch for tight low grades to become the perceived bargains of 2011.**

In February, transportation was a headache for everyone from every origin in North America to every destination. With inclement weather across at least two-thirds of the continent, truckers were reluctant to take loads that would put them into a soupy situation after they had dropped off their cargo. Meanwhile, rail-switching delays were common on the CN; returning cars were not as plentiful or quick as shippers would like.

Rail transit times expanded significantly, pushing deliveries back enough to make customers fume. The rail lines insisted these delays were weather related.

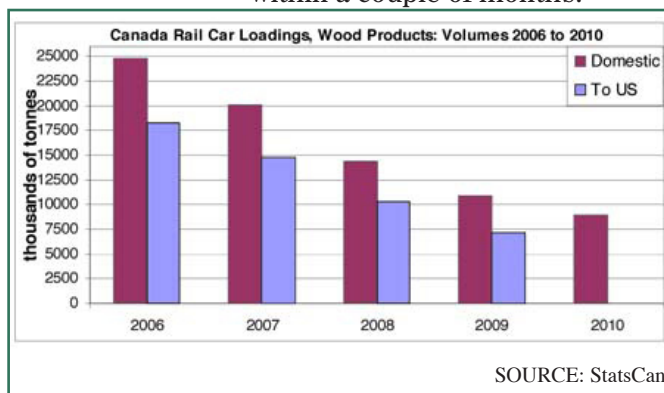
Arranging for trucks to haul loads south from Fort St. John and Dawson Creek in northern British Columbia added to traders' worries.

Transportation problems will continue through March as lumber producers poach trucks out from under each other and the railways bring back rusty, long-idled rail cars.

No one buys when weather forecasts turmoil.

MONTHLY RECAP

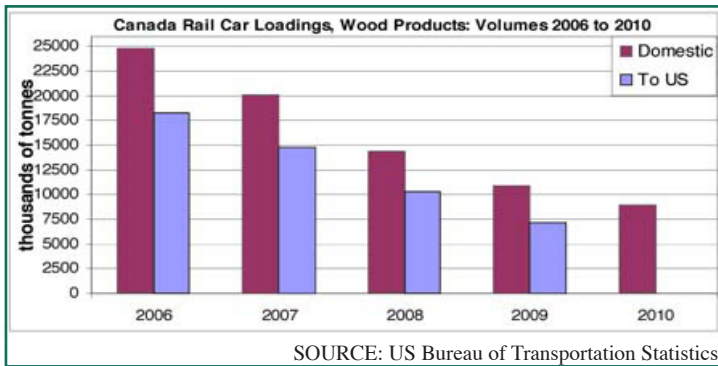
- A rise in rail rates had been expected and was implemented with the New Year.
- Ice, freezing rain and snow made shipping nearly impossible. How will players predict when the spring buy will start, as land currently snow-covered will be building sites within a couple of months?



- Winter wet green fir is heavier and that adds a few dollars to every thousand board feet delivered. Although many loyalists prefer the fir, some users will substitute with Spruce-Pine-Fir or Southern Yellow Pine when the price is right.
- Rail car shortages were reported in the Seattle area, inland Washington state and parts of Idaho.
- Transit times on the railroads were plaguing shippers, having stretched three weeks beyond quoted times on deliveries.

SHORT TERM ANALYSIS

Transportation has become even more unpredictable for the lumber industry in the past three years than usual, particularly with truckers. Uncertainty about fuel prices is causing truckers to arbitrarily impose additional fuel surcharges with the same zeal that gas stations exhibit in posting higher prices at the pump.



Problems moving lumber on the rail from and down the west coast have been reported all across North America for several months. The supply chain is used to shipping to traditional hubs like Chicago or Memphis; difficulties adjusting to the new volume of wood products headed for west coast ports are evident.

Monopoly rail lines in Canada are responding with agonizing slowness to a resurgence in lumber demand. The hub in Prince George is regularly choked as CN Rail has opened only one terminal for lumber commodities. Rail cars wait days to be sent on to ports, usually Vancouver.

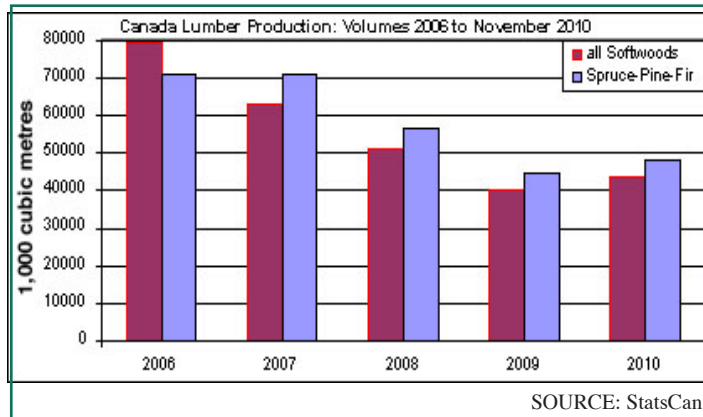
EFFECTS

CN Rail, CP Rail, Norfolk Southern, Union Pacific: generally speaking North American railways have recovered from abysmal 1Q 2009 results. Rail cars retired on sidings all across the continent are being brought out and repaired on higher demand for rail transport. Share prices are rising steadily but remain quite low compared to five years ago.

Don't let the futures board dictate your actions.

MONTHLY RECAP

- An atmosphere of uncertainty and rampant gossip initiated odd behaviors at all levels of the market, cash and futures, buying and selling. In the absence of good sense, must cash buyers now follow the cyberdirected actions of program traders in futures?



- Uncertainty caused by the continually unfolding crisis in the Middle East brought turmoil to commodity and financial markets of all kinds, with lumber futures being no exception.
- As speculators mull over possible action, or inaction, futures boards react in unpredictable ways.
- Interest in the March contract waned almost completely by market close on February 25, while the May contract closed the gap below the 100 day moving average that day to settle above.

SHORT TERM ANALYSIS

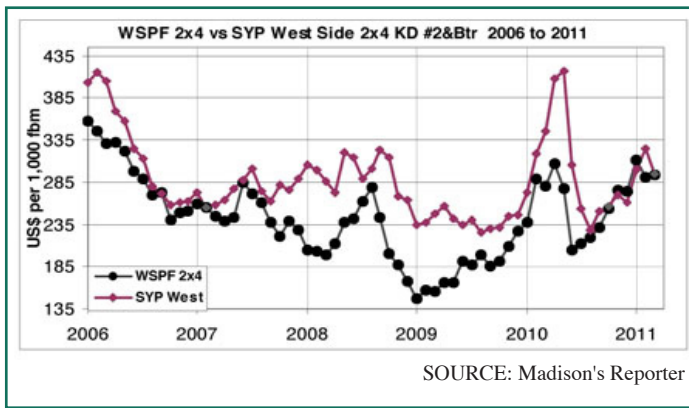
Using lumber futures as a hedge against fluctuations in cash prices becomes more risky as the

disconnect between current realities of supply and demand in the lumber industry and emotional reactions to floundering US home building and unrest in the Middle East grows.

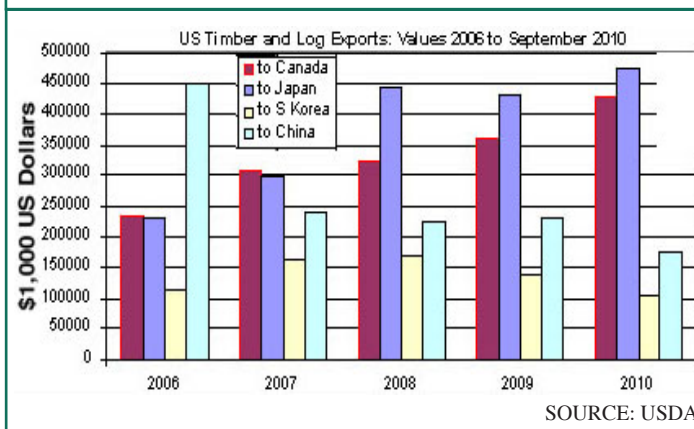
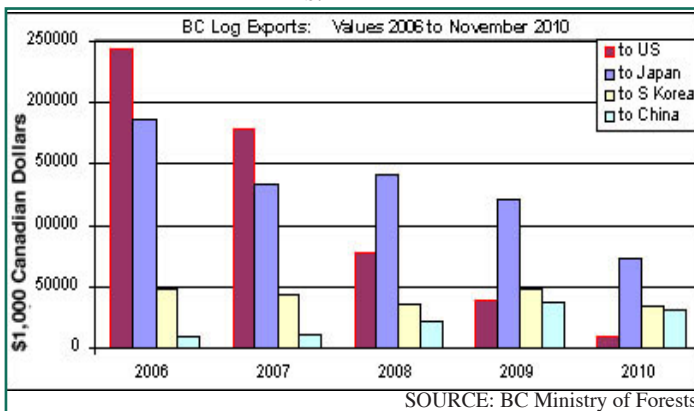


Traditionally, based on real demand, lumber prices start firming in April. Spring is right around the corner yet mill capacity, while improved over 2009, is still restricted and log yards are woefully understocked. Old economic performance models based on US home building numbers that haven't yet recovered and that don't take into

account new Asian customers will not prepare lumber producers and investors for the next two years.



have spiked above \$650 on the Scribner's scale in Oregon, thanks to off shore log buyers scooping them from under mills. It's not only the devalued US dollar that inspires foreign log sales; it's also the willingness of American log sellers to under-cut their own mills.



Rather than being a leader, lumber futures have been following a wayward path vaguely behind cash lumber prices in the past year. Speculators are unlikely to realize they are out of step with a pending recovery of lumber demand within the next three months.

The bears slept while the bulls sharpened their horns.

MONTHLY RECAP

- KD Douglas fir mill operators threaten to shut-down if prices fall below \$260 mfbm. Log prices
- As with KD fir, green fir makers are unwilling to take extended orders files at these lower price levels. They would rather wait out the winter than commit to selling their finished lumber below the replacement cost for the logs.
- Customers are “shopping it to death,” said one source.
- In spite of the shortage of logs, customers won't buy even on fear if they are sure they have no immediate needs. Douglas fir is a market segment where much of demand is emotional.
- Just in time for the end of February, customers slowly awakened from their long winter nap. Both 2x4 and 2x6 pushed up substantially to make a better week for producers. Although business was slim east of the Rockies, the west coast almost made up for that lack.

SHORT TERM ANALYSIS

The story of US west coast mills pricing themselves out of lumber production may be about to wind down. Through 2010 many Washington State and Oregon mills survived by selling logs, in the end fueling demand for timber from Asia, while Douglas fir lumber prices remained ex-

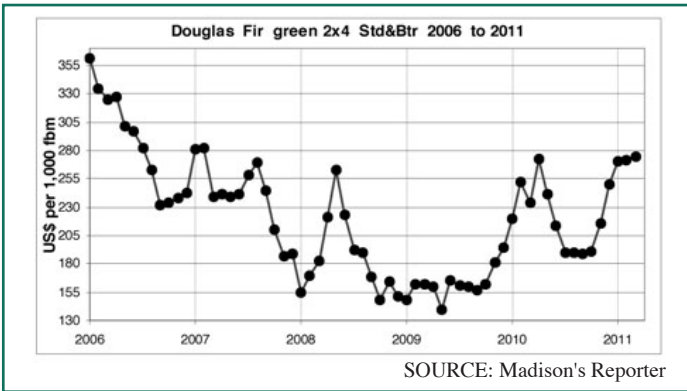
remely soft so that they could not afford to run their own logs. A highly valued product by loyal customers, Douglas fir demand has suffered while the traditional customer base in the US northeast backed out of the market.

Does a small surge in demand at the end of February indicate a recovery from weak Douglas fir lumber prices, or will the powerful hunger for raw logs from Asia continue the log/lumber price imbalance?

EFFECTS

Weyerhaeuser, Western Forest Products: WY is, by and large, out of the lumber producing game and has become a log supplier, having converted to a REIT in late 2010. In a bizarre twist of circumstances, sources report WY has been forced to buy logs from outside sources in this very tight market. Company share prices show some recovery after taking a real beating during structural changes. Meanwhile, WEF

showed a profit in 1Q 2011 a on one-time asset sale of land to TimberWest. Company share prices continue extremely low on continued uncertainty about coastal lumber operations and lack of confidence in bondholders running the company.



Watch for tight low grades to become the perceived bargains of 2011.

MONTHLY RECAP

- McMansions, currently in disfavour by mid-market home buyers during this uncertain time, are the prime users of 2x12. With new home construction on hold, the wider products are not needed for the DIY and secondary market of home renovations.
- The demand for studs is not price related, according to one trader.

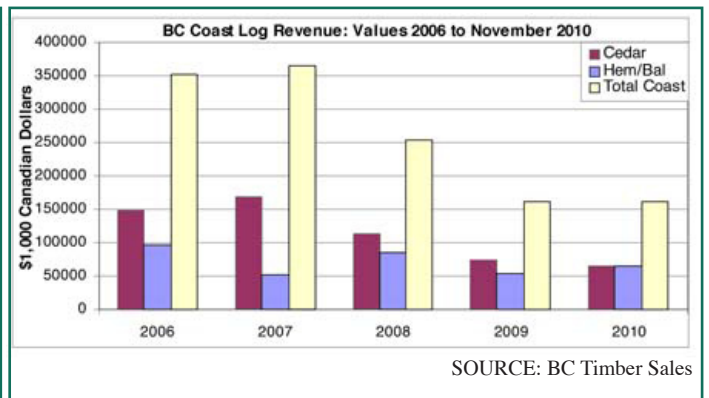
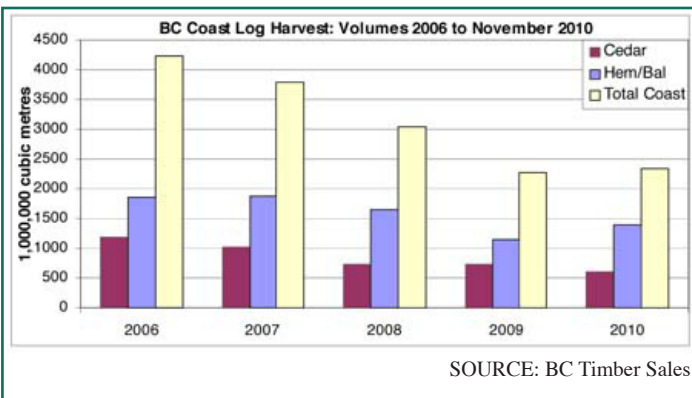
SHORT TERM ANALYSIS

Since 2007 the North American lumber industry has been sustained by DIY projects and an explosion of demand out of Asia. While a niche market for high quality products remains, production volumes continue to be impacted. Once US home building does resume in earnest, these homes will feature an emphasis on sustainability, value, low energy costs, and inexpensive materials in addition to being smaller by an expected 100 square feet than the so-called McMansions.

With the exception of a massive storm, current levels of renovation will likely not bring a substantial increase in demand for higher value products in the medium-term future.

EFFECTS

Western Forest Products, TimberWest: Loggers will start getting called back on the coast through 2011, although WEF has not yet made a significant move. The timber supply chain is seriously constricted, getting logs moving again is going to be cumbersome. TWF are not yet running at capacity, and the company continues to export logs. Company share prices remain soft during adjustment to a focus on real estate sales.



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