MADISON'S Investment Rx

PO Box 2486, Vancouver, BC V6B 3W7 ❖ Tel: 604-984-6838 ❖ Email: madrep@shawcable.com ❖ Web: www.madisonsreport.com

March Lumber Market Analysis

By Kéta Kosman
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OVERVIEW

Despite seemingly endless rounds of March spring-break holidays, scheduled for different times depending on which part of the continent a person was in, and a looming early-April Easter long weekend, North American lumber and panel prices in March remained essentially steady.

Transportation was the name of the game in March. The nature of these problems provided an ominous foreshadowing of possible complications as this year wears on. Sawmills seemed to take great exception to the usual spring freight price increases in North America. To be surprised at an event which happens every year seems odd, but such is the working of producing and moving lumber these days.

The inside word is that log haulers and lumber truckers, already in short supply, will become even more difficult to book following the annual winter return home of India-born operators. The growing economy of that country is providing lucrative opportunities, and several trucking companies have already announced the small likelihood of their drivers' returning to Canada or the US this summer.

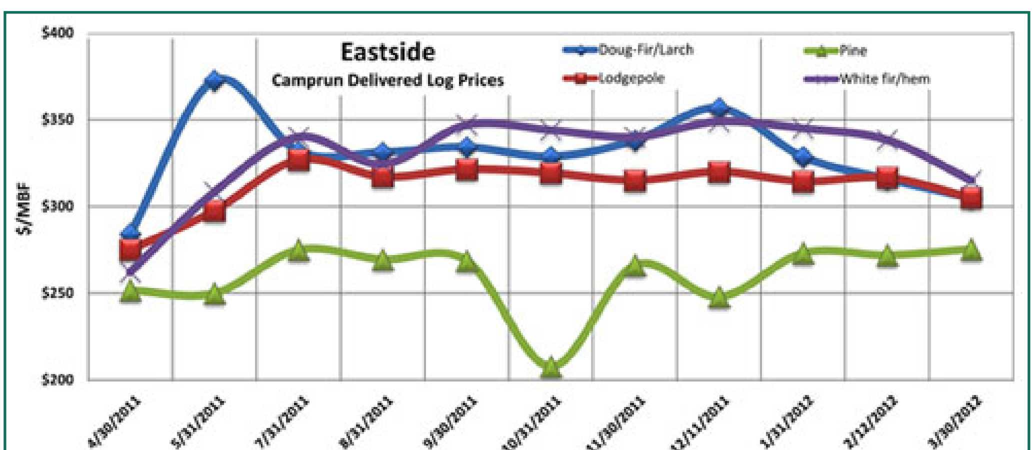
The railways will be forced to take up the slack as wood sales volumes rise. This will present problems of its own; between bad maintenance cars getting flagged AFTER leaving the mill fully loaded, and regional issues with one service provider in a monopoly position dictating to customers when and how many cars they will get. Then not complying with its own terms.

- **Rail-transportation felt the squeeze as trucks continued to get more scarce.**
- **The spring break week brought lumber demand to as flat as it gets.**

At least one analyst has already made the bold move of declaring the 2012 spring season for lumber products' sales over. That prediction can safely be labelled as premature in the extreme, even as US housing starts for March dropped by 5.8 per cent over the previous month. March permits were up, once again, this time by 4.5 per cent, compared to February. That figure greatly exceeded analysts' expectations of 0.3 per cent.

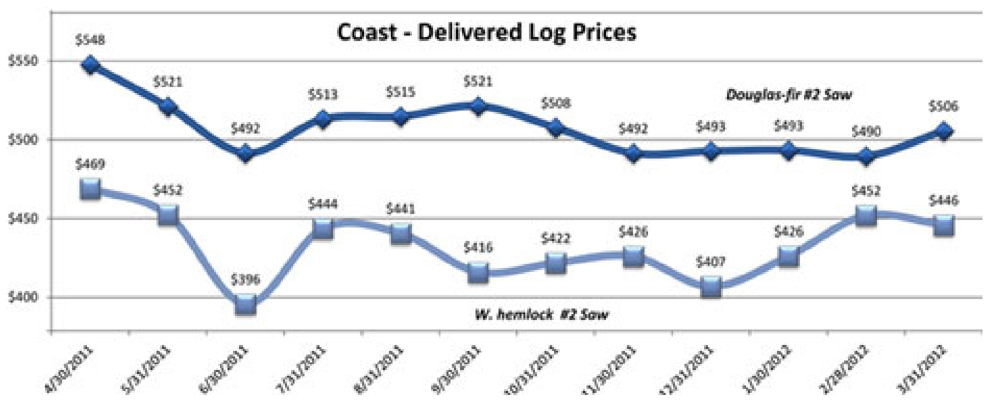
Rail-transportation felt the squeeze as trucks continued to get more scarce.

MONTHLY RECAP



SOURCE: Washington State Dept of Natural Resources

- In the first week of March previously announced freight increases for both rail and truck transportation were implemented, driving up the nominal cost of doing business.
- Good weather in the second week of March somewhat offset "brutal" supply chain logistics.



SOURCE: Washington State Dept of Natural Resources

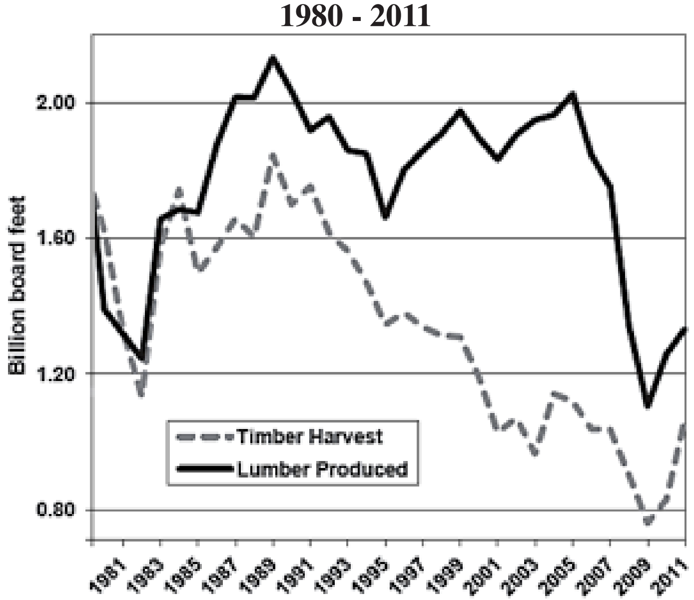
- In the third week of March, the biggest problem faced by traders was the shortage of trucks. Logs were being roadside-decked in anticipation of drier weather, when it will be easier to get trucks in and out.
- Long-mothballed rail cars finally came out of storage toward the end of March to shoulder the transport burden associated with growing demand.

SHORT TERM ANALYSIS

In addition to the looming supply crunch in solid wood products, as explained below, are approaching transportation problems of staggering proportions. These will take longer than the 2012 summer season to work out. Much longer.

In 2009 there was an epic loss of solid wood transporters. The now-infamous decision by Arrow Trucking to lock drivers out of their gas cards upon delivery of their last loads on Christmas week in 2009 will go down in history as both rash and treacherous. The company filed for bankruptcy on January 8, 2010.

Idaho Timber Harvest and Lumber Production 1980 - 2011



SOURCES: Bureau of Business and Economic Research, The Univesity of Montana-Missoula; USDA Forest Service Region ne, Missoula Montana; Western Wood Products Association

Since the height of US home building, fully one-third of all truck loggers AND of lumber truckers in North America went out of business. Their equipment was repossessed. Those people are now either retired, working in other sectors, or in different jobs. Those still in business have expressed such bitterness about their treatment by the lumber companies that they vowed never to return to that industry.

The strength of this assertion remains to be seen of course, when mills start "showing the money". The example of late 2010, when the volume of orders from Asia collided with ports simply unprepared for the increase, is apt. At that time, western mills paid truckers a handsome premium to haul wood down the west coast until a port with room for additional containers was found.

The challenges about to unfold in log and lumber transportation logistics will likely take more than two years to sort out. Securing financing and setting up operations for a viable transport company in an uncertain sector like the lumber industry takes longer than a few months to complete. In the meantime, those companies still in business are sure to make out like bandits.

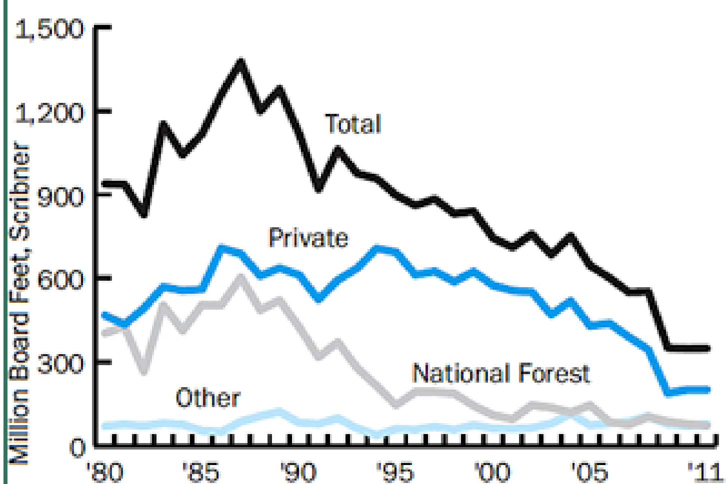
The spring break week brought lumber demand to as flat as it gets.

MONTHLY RECAP

- By mid-March, sluggish trading in WSPF persisted, following on the heels of the downturn in activity the previous week.
- At the same time in the East, secondary buyers hadn't caught up with the supply-demand balance yet and were making their frugality apparent.
- Buyers, exhibiting short term interest only, had trouble securing their inventories and were constantly coming back for more transactions.
- Now that the economy is emerging from the recession, those players who look ahead several turns with every move will be rewarded.

SHORT TERM ANALYSIS

Montana's Timber Harvest by Ownership Class 1980 - 2011



SOURCES: Bureau of Business and Economic Research, The University of Montana; US Forest Service Region One

An objective observer can see where this 'looking backward' mentality is going to end. By this time in 2007 it was apparent to anyone with the slightest interest in the business of lumber that things had gone horribly wrong. In the intervening five years, the practice of Just-In-Time buying has become entrenched across species and commodities. Previous to 2006, JIT was a play not for the faint of heart, nor for anyone trying to put a quarterly business plan into action.

Five years is a long time to be in a habit. Producers had responded to the pitiful, miniscule, highly-specified orders by cutting production. It has been three years since the long lengths, 22' and 24', have been available in significant volumes. The same is true in wides: very little 2x12 specified lengths on the west side, and 2x8 to 2x12 straight lengths in the east. This is also true on the US south, for southern yellow pine. Customers looking for these dimensions are relegated to specialty orders at premium prices.

Part of the reason is the lack of big logs, as mill yards have long been picked through and investment in timber harvesting remains muted.

This example of a dearth of longer and wider sizes can easily be translated into the more usual commodity groups. By mid-2007 customers realized that producers had lost their bargaining edge; demand dropped to such a degree that every lumber order to the mill was entertained, no matter how petty. Not only that, delivery was promised within a week, or ten days at the latest. Even with the abundance of mill closures, downtimes, and curtailments, there was still not enough demand to tax a regular sawmill running on half-time.

Before we know it customers will be in a panic because end-users will be asking for volumes of wood not seen in years. Retailers, big box stores, and US home builders will be shoring up inventories for the first time since mid-2006. While mills are ready to ramp up production, and some have even taken the step of calling loggers back into the woods, there will be an inevitable time lag between the spike in demand and that demand being served.

Cash prices will of course respond accordingly.

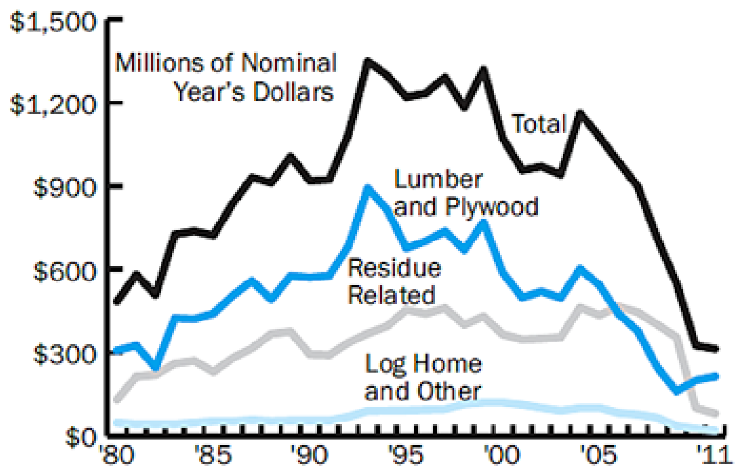
Futures, having of late become a sleepy forum into which mills can rest their hedges and funds can place neverending shorts, will become unintelligible. The common practice of simply liquidating a short position or rolling it to a more deferred month will suddenly no longer pay off. Sorry, not pay off. Break even.

By the time the situation gets sorted out, autumn will be approaching. Some will be jumping for joy while others will be left crying in their shirtsleeves.

CONCLUSION

While there has traditionally been, historically on average, a drop in lumber prices following the spring buy and leading into the summer season, in 2012 circumstances are such that this trend is not likely to materialize. In previous years factors such as powerful storms in the US, massive wildfires in Canada, labour disputes, or others, have bucked the typical annual lumber price cycle. In short, any disruption to the supply-demand balance can affect prices. Sometimes wildly.

Sales Values from Montana's Primary Wood Products Industry 1980 - 2011



SOURCES: Bureau of Business and Economic Research, The University of Montana; Western Wood Products Association.

In 2003 benchmark WSPF 2x4 KD #2&Btr dimension lumber prices rose steadily from an extreme low of US$210 mfbm at the start of the year to US$358 in September, then dropped to around $300 at year-end. That summer British Columbia had experienced its worst wildfire season in its history, coastal forestry workers in BC were mired in contract negotiations with employers, and Hurricane Isabel hit the US east coast in early September.

Conversely, in 2000 the same commodity price tanked inexorably from US$330 mfbm in January to finish the year at US$181. That price recovered sharply in the first five months of 2001, to US$335, at a time when US housing starts were relatively stable. It was the approaching culmination of rampant mergers and consolidations of North America's solid wood operations that resulted in the unusual, steady decline of lumber prices through 2000 and the sharp recovery at the start of the following year. Newly merged companies had to go through the process of reconciling, closing, or upgrading various production facilities.

Please see last month's issue of your *Madison's Investment Rx* for 10-year price graph.

In the same way, 2012 is a year which follows a series of massive changes and shifts in the basic business model of making lumber and panel. It is not simply a case of looking at the usual seasonal factors of past years to determine what will happen to the market as this year continues to unfold.