MADISON'S Investment Rx

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February Lumber Market Analysis

By Kéta Kosman
March 17, 2013

OVERVIEW

In January the big seller was panels; OSB and plywood, particularly in the east, experienced monumental price gains. Come February though, consumer interest shifted to studs. Continued strong demand and significant supply restrictions combined to push studs prices up higher than anyone would have imagined a few short months ago. In Canada, studs producers fielded a surprising level of inquiry from China. The requisite price hikes on studs in the US followed suit within a few weeks.

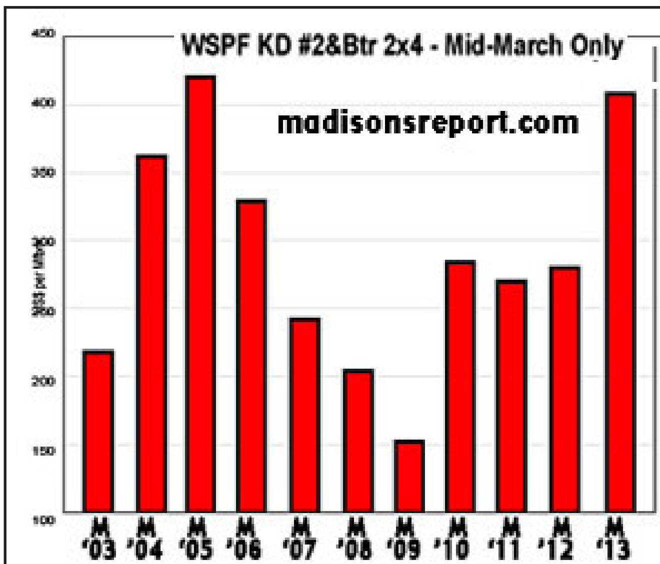
The question on the minds of all those in the business of selling and buying lumber right now is: will these current high price levels stabilize, and translate into large volume trades as spring buying gears up; or, will prices continue to rise, causing customers to step back and re-evaluate their buying habits of the past five quarters?

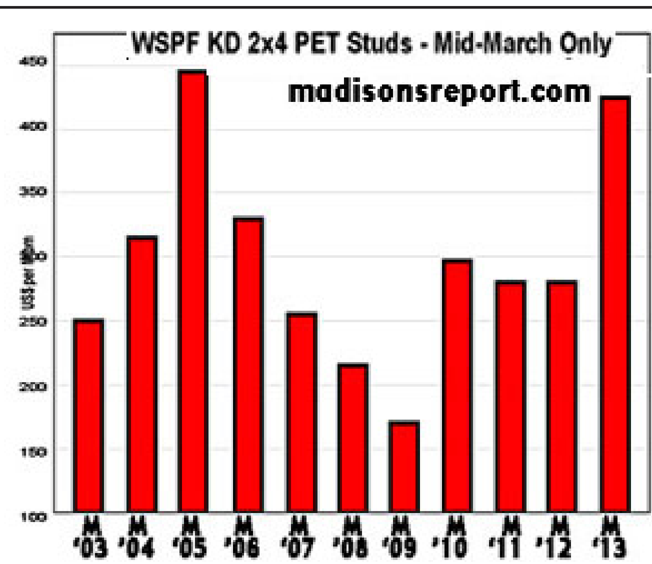
A consistently perplexing lumber futures trading board is causing a lot of uncertainty. By any measure of logic, the May futures contract became monumentally enticing in the second week of March, but speculators didn't respond as expected. This strange reaction by speculative funds and institutional investors is forcing lumber producers to wonder what is actually going on in the market.

As *Madison's* source at FCStone put it Friday, March 15, "WSPF 2x4 and 2x6 were in a kind of bizarre multi-tiered market where mills raised prices on #2&Btr spot while struggling to EFP the same fiber $10 or $15 below their own offer levels."

If producers can not, through futures, unload rail cars of actual lumber at a 3 or 4 per cent discount to cash yet are consistently raising cash prices on the strength of ever-growing sawmill order files, something is going to have to give.

"Unless cash completely runs away, the fund will absolutely have to participate to generate sufficient momentum to grind through the resting mill sell orders above the market. Without the push, futures are likely to flounder and continue to churn in horrific volume," said FCStone the day the March contract closed. By then almost all futures trading was in the next contract, for May, as is usual when a contract closes.



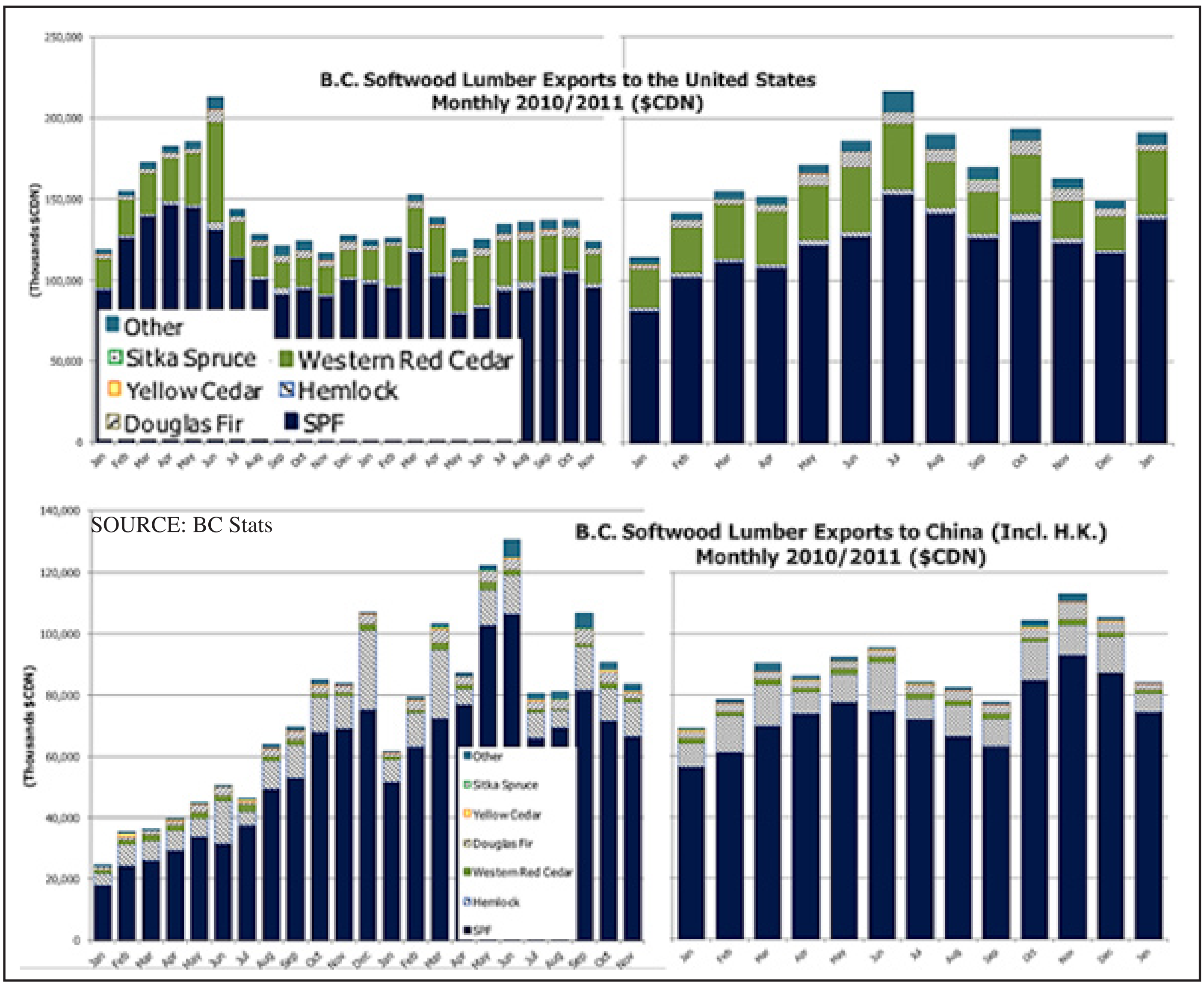


Key ideas for February 2013 lumber and panel markets:

- **Strong demand and surging lumber futures translated into impressive price increases.**
- **Sales slowed slightly this week as buyers desperately resisted strong price levels.**
- **A winter-weather related drop in inquiry wasn't enough to pull prices down.**

It is not the opinion of *Madison's* that cash is going to "completely run away". As of the end of February there was still something in the order of 15 per cent sawmill capacity across North America waiting to come back online. That is a lot of wood still to come up for sale. If producer order files remain at between 3 and 5 weeks as they have been for several months running, mills will have to start producing more wood.

The question then is not so much what the funds and investors in futures are going to do – someone is going to take a serious bath eventually if this keeps up – but how the mills are going to get the logs to make more lumber. The seeming panic about sluggish futures trading is going to pale in comparison to the absolute hysteria that will ensue come August when suppliers realize they have zero ability to significantly increase fibre supply to their mills.



Strong demand and surging lumber futures translated into impressive price increases.

MONTHLY RECAP

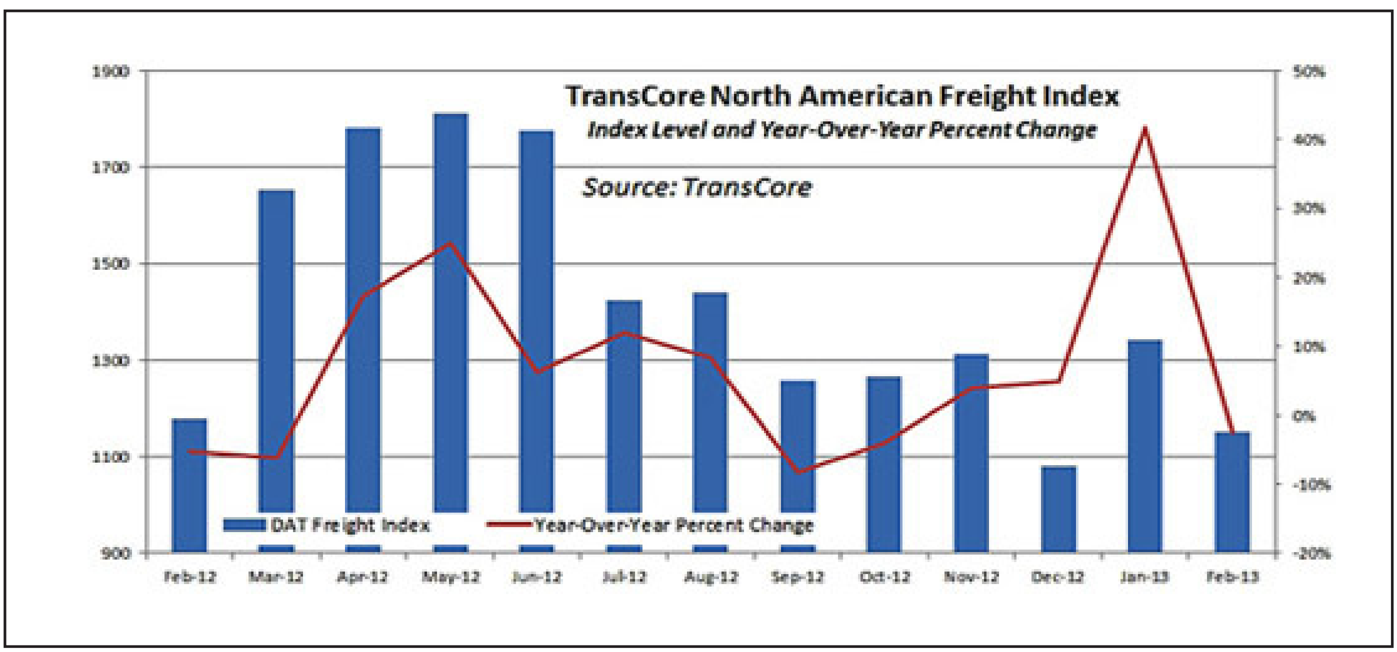
- In the last week of January, WSPF prices found a bottom off which they immediately, and aggressively, bounced.
- At the beginning of February, Eastern spruce customers who had waited to buy, in an attempt to talk sellers down, were wishing they had bought earlier.
- Douglas fir customers were pouncing on any load of utility grade 2x4s they could find.
- An apparent lull in demand at the end of January brought studs-buyers rushing back to the negotiating table.
- There was even less KD Douglas fir to buy in the first week of February than there was the previous week.

SHORT TERM ANALYSIS

As February waxed the lack of lumber supply, coupled with the abundance of demand and continually optimistic forecasts for US housing starts, pushed prices skyward, as had the substantial upward movement in lumber futures. Customers responded by refusing to buy. Producers ruthlessly scoffed at counter-offers. Phones were slammed down in immense frustration. Buyers invariably called back the next day saying they'd accept the previously-offered deal. If they were lucky the price had not gone up, yet again, in the meantime. Repeat this drama week after week for quite a few months.

Until secondary suppliers; the reloads, wholesalers, big builders, and box stores, start carrying inventory in earnest this situation is going to continue. Sawmills know that no one has been building inventory, that players of all kinds can only order from producers, and thus are crafting their near-term business plans accordingly.

In the first week of February, sales volumes were excellent for American traders, some even going so far as to rank it as a nine-out-of-ten week. Meanwhile, in Canada the ground was still firm enough in the winter weather to make hauling timber out of the bush relatively painless.



On the coast, KD Douglas fir customers needed yet more loads of logs even as they watched their inventories dwindle to dangerously low levels. KD Douglas fir sawmills basked in the strong demand, and were back to their enviable position of late 2012, booking orders further and further out.

Sales slowed slightly this week as buyers desperately resisted strong price levels.

MONTHLY RECAP

- In mid-February the frantic sales pace of WSPF commodities slowed, but remained encouraging. Demand was mainly in the form of reluctant, last-minute buying from desperate customers.
- Continued bad weather in the US east and midwest slowed ESPF production somewhat but did little to hamper imminent customer need to buy.
- Hot demand for Western species earlier in the month translated to increasing prices for ESPF products after the middle of February.
- Stocking wholesalers in the US northeast reported that secondary suppliers had been selling well below mill-replacement for most of February.

SHORT TERM ANALYSIS

Relentless inventory shortages across almost all lumber and panel commodity groups are going to manifest into real problems as spring officially takes hold. The US building season this year may be a short one, or it may last well into August. In any case, both timber harvesting and sawmill capacity are currently not at levels high enough to handle the inevitable increased demand for wood. In fact neither is operating at levels high enough to handle current demand.

Sawmill order files of six weeks or two months, or longer, heading into spring do not bode well for those looking to source wood in the spring and summer months. Traditionally, during normal seasonal building cycles, lumber prices peak in April. They will generally stay high through May and possibly the beginning of June as lumber already ordered gets digested through the supply chain.

This year lumber and panel prices were rising steadily prior to January, based largely on US demand but also due to healthy sales into China and Japan. It is difficult to see any downward movement in solid wood prices before mid-summer, if then. Should the unthinkable happen – a serious forest fire in BC for example – the ensuing panic will absolutely cause prices to jump. Otherwise, expect stable pricing at current levels to become the norm for this year.

A winter-weather related drop in inquiry wasn't enough to pull prices down.

MONTHLY RECAP

- As February waned, prices on WSPF defiantly maintained their levels even as demand downshifted again.
- Tightened lending conditions prevented customers from building up their inventories in advance of spring.
- Hot demand for studs drove prices on that commodity up ever higher as players could only stare in wonder.
- By the end of February, ESPF producers knew the claims of their customers that they could get better prices elsewhere were false because there wasn't enough wood available anywhere.
- Vendors in the US northeast were shocked when green Douglas fir prices outstripped dry delivered to their region.

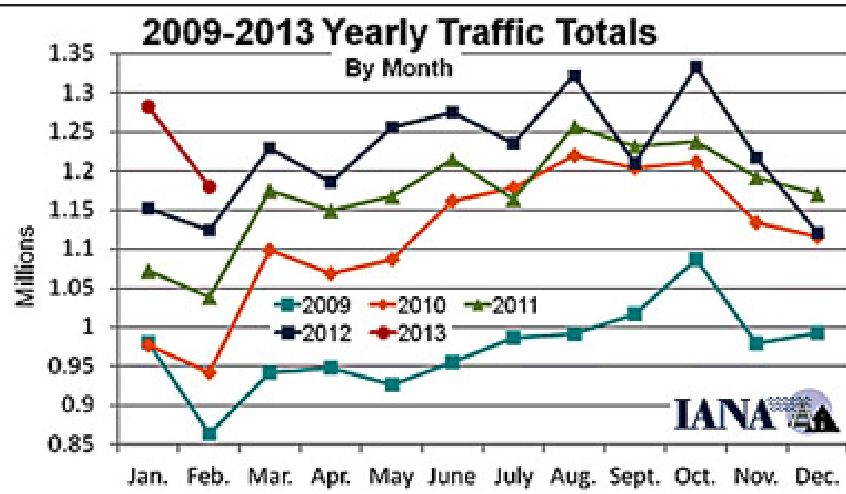
SHORT TERM ANALYSIS

By the end of February demand had cooled just enough, for just long enough, to stablize prices on most commodities. Only Douglas fir, with log supply so dangerously low, continued the relentless upward pressure on prices begun in late January. Indeed coastal lumber processing in general seems to be headed toward some difficulties this spring season. Cedar mills in Canada and Douglas fir mills in the US have been consistently reporting extreme problems sourcing logs, either due to lack of harvesting operations or high prices. Or both.

Finished cedar product prices don't move the same way as other solid wood commodities, with prices stepping up or down on a weekly basis. Cedar prices are adjusted in large jumps, always upward, by quarter as the large volume producers take into account program buying in the US and Japan. Cedar prices will stay flat for months on end then jump by hundreds of dollars over a few short weeks as suppliers increase their lists and test the marketplace for resistance. Given the extended fibre supply difficulties being experienced on the coast, the logical expectation is that when the adjustment process occurs next those price hikes will be by a greater degree than seen in past couple of decades.

One of the main competitors with cedar products is treated southern yellow pine decking, siding, trim, etc., which is obviously a very poor second cousin to the much better quality, and longer lasting, cedar. Other than that there is only the artificial outdoor furniture and home-finishing materials. In most cases the desire for the good quality, higher status cedar product is not lessened by steep seasonal price hikes.

The expected larger price hikes on cedar commodities this coming season will likely do nothing to decrease demand from such dedicated customers.



CONCLUSION

As February drew to a close the standard refrain of uncooperative railway companies became a battle cry. The dearth of rail cars, and the maddening inconsistency of their eventual arrival – or not – was even worse than usual for the season. Sawmills and customers relying on the Canadian rail lines became alarmed at the inability to get the minimum of rail cars needed to move product. By the end of February some had completely given up and were calling up long-idled truckers. An expensive and cumbersome solution which can not last as spring takes hold and fresh produce starts moving on North American highways.

The railways offered the usual excuses of weather-related problems, claiming week after week that cars were merely delayed, but veteran players felt strongly that something much more serious was going on.

If the lack of basic rail service continues into spring, the already depleted supply chain is going to be severely impacted. This is a uniquely Canadian problem, as only the CN and CP serve the remote forest operations in large parts of Canada. Some of these sawmill operations don't even have a decent highway system to turn to. Should the railway incompetence continue, some Canadian lumber producers will have operations seriously hampered while others – those with highways or an inland port nearby – will make out like bandits.