



# MADISON'S TIMBER PREVIEW

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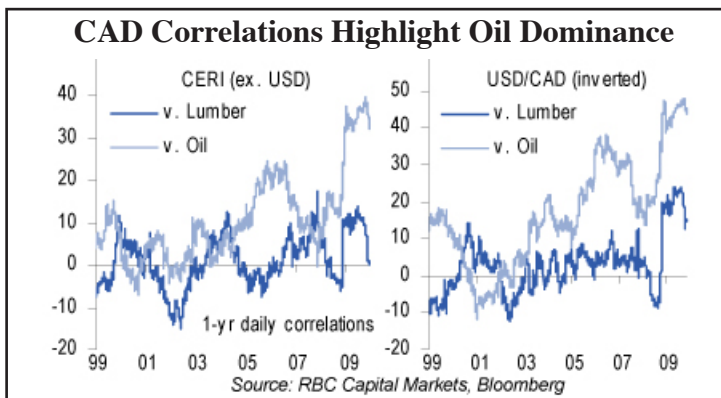
As this year winds down, the forest industry and analysts alike are looking to what the next year will bring. 2009 has been unusual for the wood products industry, with several circumstances in terms of logistics, production and sales, having changed permanently. The long awaited recovery of US home building is the source of a wide range of speculation, however most agree that a slow rebound will be in place by mid-2010, with more robust new home numbers coming into 2011. However home building in the US is not the only factor affecting North American lumber production and sales.

David Watt, Senior Currency Strategist at RBC Dominion Securities, released a report on November 20 examining "recent developments in Chinese building codes that clarify rules for wood-frame construction," and saying that "changes to the Shanghai Local Code adds to bullish CAD risks in 2010 and beyond. A longer term bullish CAD stance predicated on oil should be extended to include lumber."

Crude oil, Canada's biggest export with 21 per cent Bank of Canada's Commodity Price Index, gets the lion's share of attention in discussions about the Canadian currency, Watt said. Even so, lumber, which is often overlooked, "could be the oil of the next decade," he wrote. Lumber accounts for 14 per cent of the BoC's Index.

Lumber, an industry that has been "under the cudgel" due to the US housing crisis, may rival crude oil and base metals as one of the primary drivers of the Canadian dollar, Watt said.

Looking at correlations between USD/CAD and CAD's effective exchange rate excluding USD, the correlation with oil has strongly dominated that with lumber for the past several years.



A surge of interest and investment in commodities of late seems to confirm Watt's assessment.

Scotiabank's Commodity Price Index for October, released November 30, rose 6.8 per cent when compared to September. The All Items Index advanced by 11.4 per cent from its cyclical low in April 2009. Recent weakness in the US dollar, particularly against the Euro, has continued to boost commodity prices into November, with investors attracted to hard assets such as gold, silver and copper.

Copper list prices, a leading indicator to new US home building, climbed from US\$2.81 per pound in September to US\$2.85 in October, rising to a near-term peak of US\$3.15 on November 23. While prices have since edged down, copper remained exceptionally lucrative at US\$3.06 in late November, yielding a profit margin of 58 per cent over average world breakeven costs, according to the Scotiabank release. China has massively restocked copper in 2009, taking advantage of bargain prices, and now holds about 800,000 tonnes, of which 200,000 tonnes are held by the Strategic Reserve Bureau. China's copper imports fell by 40 per cent in October compared to September, but were still at normal levels compared with 2007-08, and prices were little impacted. Scotiabank's Forest Products Index strengthened markedly in October, up 3.1 per cent compared to September.

"Newsprint prices are beginning to pull up rapidly from levels below average cash costs for North American mills," said Patricia Mohr, Vice-President, Economics and Commodity Market Specialist at Scotiabank. "Tight world supplies also boosted NBSK pulp prices to US\$800 per tonne in the United States in October (an eleven-month high) and to US\$830 in November, encouraging the re-start of some Canadian pulp mills. A stronger yen against the US dollar is also allowing BC 'J-grade' lumber producers to boost prices in Japan - good news for Canada's hard-pressed forest products industry."

Shares of several of Canada's largest lumber exporters have risen sharply in the past two months as new building codes in China allowing wood in construction have cracked open a previously inaccessible market for Canada's long-suffering forestry industry. Since October 1, shares in International Forest Products have soared 58 per cent, while Canfor Corp. and West Fraser Timber shares jumped 31 per cent and 28 per cent, respectively. Ainsworth Lumber has also seen an improvement in share prices, of 27 per cent, from \$1.58 on November 03, to \$2.23 on December 01. South of the border, lumber producers are showing similar positive results. Paper manufacturer Temple-Inland shares surged 6 per cent Tuesday, hitting a new 52-week high of \$19.44.

Meanwhile, the probability that the Canadian currency will trade at C\$1 per US dollar in 12 months is 78 per cent, according to implied volatility from options trading monitored by Bloomberg. RBC predicts the currency will strengthen to C\$1.01 by the middle of next year. The median forecast of 38 economists in a Bloomberg News survey is for the loonie to appreciate to C\$1.04 in that period.

In terms of the US economy, the Institute of Supply Management's non-manufacturing index represents a huge part of the overall economy and its performance hinges in large part on the health of the consumer. The ISM service-sector reading for November came in at 48.7, below last month's 50.6. Critically, it was below 50, the dividing line between an expanding service sector and a contracting one. The negative report threw analysts into confusion, having followed quickly on the heels of several positive indicators in other areas.

TD Securities economics strategist Millan Mulraine told the Globe and Mail, "Given the positive tone of other recent economic indicators and reports (such as the strong housing sector reports and the Fed's Beige Book), suggesting that the US economic recovery may have gained some traction in Q4, we are inclined to believe that this dip in the ISM non-manufacturing index may be temporary."

This sentiment was echoed by Anthony Nieves, chair of the ISM's Non-Manufacturing Business Survey Committee, who said, "I see that as more sideways than anything. One factor in November's decline was employment. While it did go up in November, it only rose 0.5 percentage points to 41.6 percent, which still qualifies as contracting. It has been below 50 per cent for 22 out of the last 23 months. We know that employment is dragging the index down."

Even this, however, was not a shock, Nieves continued. Typically, business activity hits a slump in the late fourth quarter, starting in November. In fact, business activity may not pick up until February of 2010. In the face of normal annual business cycles, determining the degree of worsening or improvement of the US economy at this stage of 2009 is not a simple task. Many analysts agree that unemployment, which is rising more slowly, will be the last indicator to signal a true strengthening of the US economy.

Meanwhile Canadian companies would do well to continue to foster new trade relationships and gain new customers in emerging markets internationally.

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