



MADISON'S TIMBER PREVIEW

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Solid wood companies across North America are letting out a collective gasp this week as lumber commodity prices continue on a desperate slide, started a few weeks ago, back down to 2010 lows. The North American stock exchanges, including Toronto and New York, are experiencing serious price corrections. Investors scramble for insight on which way markets will go, and when. The dismal days of 2009 may be behind us, but the glowing expectations forecast for 2011 and beyond have not yet germinated.

For lumber producers, watching commodity prices rise nicely only to drop again almost immediately must be maddening. Several companies reported profits for 1Q 2010, but -- if demand continues to soften -- will likely return to showing losses for the final months of this year. Meanwhile pulp producers, riding a high through 2009 sustained by unexpected demand out of China, are beginning to see demand for market pulp soften and inventories increase. Newsprint however, last in the supply chain and also an indicator of the health of the newspaper industry -- usually the last to recover in an economic rebound -- is finally showing some price firming.

In which indicator should an investor put the most trust? That depends on which market segment draws one's attention. At the PricewaterhouseCooper's annual Forestry and Paper Conference last week in Vancouver, Managing Director of US Equity Research for North American Paper and Packaging at Credit Suisse, Chip Dillon, told attendees, "Get involved in lumber until 2013 then get into timberland post the mountain pine beetle infestation."

The Dow Jones industrial average closed down 376.36 points or 3.6 per cent Thursday -- its biggest one-day swoon since March, 2009. All 30 members of the blue-chip index fell. The broader S&P 500 closed down 43.46 points or 3.9 per cent, hitting its lowest point since mid-February of this year. In Canada, the S&P/TSX composite index closed down 259.82 points or 2.2 per cent.

The world's most important stock market index, the S&P 500, has fallen a total of 12.2 per cent since its most recent high in April 2010. That conforms to an official correction, which is loosely defined as a decline of 10 per cent or more -- the index's first correction of this magnitude since the market began to recover in March 2009. As well, the index has fallen this week below its 200-day moving average, which is seen by some observers as a bearish move.

Ruled by perception, stock markets are strongly affected by the mood among investors, which has undergone a dramatic shift. Growing worries that the debt crisis in Europe could spread and that Chinese economic growth could slow, thus snuffing out the tenuous global recovery, replace recent ebullience about a global economic rebound.

Currency markets are faring no better.

Panic selling and over-reactions reach beyond international stock markets, as the lumber futures market plummets due to a perceived glut of inventory. At the Chicago Mercantile Exchange the lead lumber contract has gone from \$327.50 per thousand board feet on April 21 to \$236.00 on Thursday, May 20, a drop of 28 per cent.

Futures closed down \$7 Friday, May 14, to end the May 2010 contract at \$263. Futures were at a discount to cash at that point, as WSFP 2x4's were selling directly from producers for US\$290, and fall-

ing. Investor mood was even worse Monday, with the initial price of the July contract closing down-limit to settle at \$251. By Thursday the airline pilots and dentists who play the lumber futures market expect the price of 2x4's to go down to \$236 by mid-July. Normally such a continued drop would be scoffed at by veteran lumber traders, but falling prices in the cash market of recent weeks suggest a possibility at 2x4's may indeed be bought for US\$200 mfbm this summer.

As often happens, perception of the future may stray wildly from fact.

"The concern is we will see a flood of wood in June because there is no [export] tax," said Brian Leonard, a Chicago-based analyst with Rosenthal Collins. "At the same time, [building] activity is slowing down, so it's crushing the market."

Lumber prices may continue lower for a few more weeks as the market factors in more wood from Canada and a slowdown in home building, now that a US tax credit for new home buyers has expired. "I think we are about three-quarters of the way through the soft patch," said Paul Latta, director of research at the brokerage and investment bank McAdams Wright Ragan.

The expected drop in the softwood lumber export tax will only apply for the month of June, and -- while the US new home buyer credit has expired -- US home building is still far below what is necessary for population levels and demographics. The US has been seriously underbuilt for the past two years and is overdue for a sharp increase in home building.

Still, analysts disagree about what to do in the short term.

"I would be a buyer. We are not going to zero," said Brian Leonard, Chicago-based analyst at Rosenthal Collins. "We have broken so violently that we are overcooked right now. I think that is why we have broken so much, we know what is coming next month. The futures market is anticipating a lot of wood next month. Our declines should be limited at this point," he said.

"Futures are going down in the short term. I would be a seller over the next 30 days," explained Paul Latta, director of research at the brokerage and investment banking firm McAdams Wright Ragan. "I would then be a buyer over the next three months."

Latta said lumber futures are going through an adjustment phase related to the expiration of the home-buyer tax credit and the recent bearish actions in the equity markets. Once those factors are priced in, the lumber market could turn higher.

"I think the bottom is a couple of weeks in front of us and then it is going back up again," he said of lumber futures.

Curt Cunningham, president of Pacific Futures Trading, said he would be a seller of futures. He calculates that without the tax Canadian producers shipping lumber south can still make a profit with wood priced as low as \$230 mfbm. That compares with July's close of \$236 Thursday.

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