By Bill Nocerino, Forest2Market

2011 Lumber Forecast

The future looks better, but proceed with caution

WHAT DOES 2011 HAVE IN STORE for the lumber industry? Questions like this are difficult to answer even when the economy is healthy. When the economic data has been sending mixed signals, however, wading into the forecasting arena can be treacherous. Now, more than almost any time in our history, John Kenneth Galbraith's observation that "the only function of economic forecasting is to make astrology look respectable" rings true.

Certainly, mixed signals abound in the current economy. We saw an uptick in construction spending at the end of the year, albeit a small one. Unemployment is tracking downward, though job creation is far from the level needed to make significant inroads to a healthier unemployment number. This tension between *good* and *not good enough* is the theme for Forest2Market's 2011 forecast. We expect 2011 will be a better year for the industry than 2010, but the recovery will be painfully slow at times, continuing into 2012, 2013 and perhaps even 2014.

Housing Starts

The struggling housing market is the primary reason for the tone of this forecast. According to Standard & Poor's, the nation now has a 44-month inventory of distressed properties (up from 40 months previously), with a principal balance of $450 billion.

And this number is not likely to head in the opposite direction any time soon. Foreclosures topped 1 million in 2010. We expect they will be closer to 2 million in 2011. Recently, large banks were forced to declare foreclosure moratoriums in order to amend processes and procedures that had been called into question. Those moratoriums were temporary, however, and homes that have been in litigation limbo are starting to flood the market again. As many as 250,000 of these homes are likely to trudge through the foreclosure process in the 1st quarter of 2011.

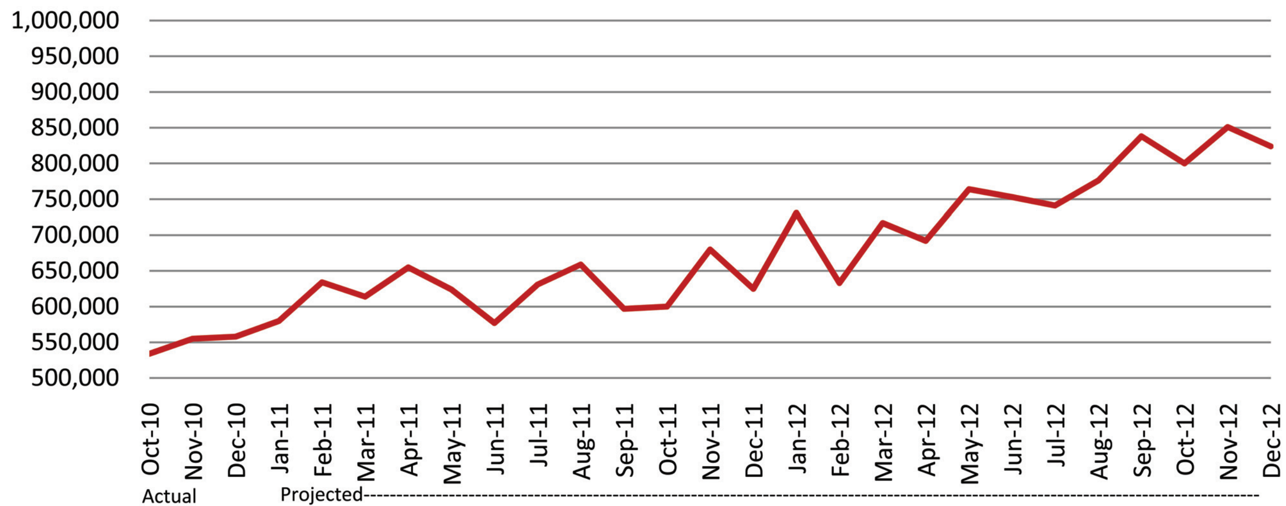
By most accounts, home prices are expected to fall another 5% to 10% over the next year. "Declining housing prices can—rather perversely—discourage home buying," noted housing expert Gary Shilling. "The remaining home equity of those with mortgages would be wiped out on average. That, in turn, would impair already-depressed consumer confidence and their willingness and ability to spend, to say nothing of residential construction."

This decline will ultimately lead to more homeowners being underwater. Unfortunately, many homeowners who are either unemployed or looking to relocate will find themselves with even fewer options and choose to walk away, thus feeding this vicious cycle.

How does all of this negative information relate to housing starts? Many appear to be ignoring much of the negative news. Some reports, for instance, have suggested that housing starts will be near 800,000 by the end of 2011, a 50% increase over last year. As much as we would love to see that, we think it is wildly optimistic.

The two main problems we are facing in housing are high unemployment and an overabundance of inventory on the market. Neither one seem to have any marked improvement on the horizon, with inventory numbers continuing to grow. Unsold inventory is 80% above its historical norm at 3.7 million units. Even in a healthy housing market, it would take time to work that inventory down to a manageable level. In reality, people are choosing to stay in their homes and make improvements instead of upgrading to bigger houses. Those who are shopping face increased scrutiny and down payment requirements. This environment of strict lending is not going away anytime soon after the hard lessons the banking industry learned and the still present litigation looming over predatory lending. That will eliminate the "marginal" buyer and limit financing only to the upper-tier of borrowers.

That being said, Forest2Market's latest Economic Outlook shows that housing starts in 2011 will average about



100,000 above 2010's level, or 625,000 annually. Not until the last four months of 2012 will the number of starts crest the 800,000 mark (*see chart above*). From there, we have more ground to cover before we reach a sustainable replacement level for housing of 1.3 million starts annually.

GDP

In addition to housing starts, GDP projections are pushing the recovery further into the future. Our outlook for GDP shows stronger than expected growth through 2nd quarter 2011 (*see chart on next page*). Projections for this period have improved, in part due to the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, which was signed into law Dec. 17. This legislation removed uncertainty about tax rates from the market and added some additional tax cuts that are likely to spur spending by both businesses and consumers.

Even though we project an uptick in GDP through the 2nd quarter, this trend will be short-lived. By 4th quarter 2011, GDP will contract, starting the second leg of a double-dip recession. While changes in legislation and monetary policy, as well as global events, have the potential to influence GDP going forward, we expect a second recession of approximately nine months, one that starts in October and ends in July 2012. By the end of our 24-month forecast period, GDP growth will return to the 2% level, setting the stage for more growth into 2013.

Lumber Industry Outlook

How will the broader economic outlook affect the southern yellow pine market in 2011? Industry performance in 2010 holds some clues.

For dimensional lumber grades #1-4, the average weighted price moved from $252 in Dec. 2009 to $263 at the end of 2010. Price changes were mixed, with almost as many dimensions/grades increasing as decreasing. All dimensions of #4 increased, while all dimensions of #3 decreased. Grades #1 and #2 were a mixed bag of ups and downs. Looking solely at price, these numbers indicate that not much has changed in the lumber market year over year. While following an upward trend, that trend is moderate.

The real story is what you find when you look beyond the numbers and focus on the supply chain. Last year at this time, sawmills were facing a log shortage. Due to the recession, mills had decreased inventory to minimal levels. Then, as the busy spring season approached, exceptionally wet winter weather made it difficult for mills to source the logs they needed to meet production demands. As a result, SYP lumber prices spiked and pushed lead times out weeks and sometimes months.

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The spike in SYP lumber prices and increased lead times produced the illusion that demand had improved. The truth, however, was that buyers had adjusted to a life of "just-in-time" purchasing. They were caught off guard by the abrupt change, and a wave of panicked buys flooded the market. Buyers saw lead times stretched from days to weeks and then, in some cases, months. Forced to buy whatever they could find, buyers were unable to counter the prices being offered. The drastically reduced number of trucks on the road and new demand from the federal housing tax credit joined the log shortage to create the "perfect storm" that ruled the market.

This chain of events will not repeat itself in 2011. The factors preventing the type of run up that characterized the market last year include the fact that sawmill inventories are much healthier this year (due to a stronger-than-forecasted 4th quarter) and that the supply of logs at mills will be sufficient to meet demand (helped by favorable weather and log prices). Instead, we predict modest growth for 2011, growth that will be driven by increased sales volume and improving market stability.

Seasonal patterns in demand dictate our forecast for growth in SYP lumber prices this year. Following long-term trends, we expect prices to rise in response to increased demand during the busy spring season, then retreat once that demand disappears.

We project SYP lumber prices will peak in the $375/MBF range sometime in the spring and then start to retreat as the hot summer months arrive. The difference between 2010 and 2011 will be the speed in which we reach those peak prices. The dramatic week over week rises we saw in 2010 will be a thing of the past. Instead, we expect a more balanced, less aggressive rise as the peak buying season approaches.

After the busy season subsides, prices will fall back below $300/MBF and bounce along that price floor through the remainder of the year, as demand will no longer be sufficient to sustain the increase in prices and production. Contrary to popular belief, even after the many closures we saw during the "Great Recession," too much production capacity is still an issue at all levels of the supply chain. Manufacturers running on one shift can easily add second and third shifts, increasing capacity dramatically as they chase higher prices. When demand starts falling, however, the higher production levels lead to oversupply in the market, and prices fall precipitously. We expect 2011 will follow this long-term pattern as well.

One difference between 2010 and 2011 is that, for the most part, lumber buyers will be able to buy "just in time" throughout the year. This will allow companies to turn product quickly and keep inventory at or close to market. This will be a welcome relief after the wild ride we experienced in the first half of 2010.

Forest2Market's *Economic Outlook* is based on tested, comprehensive econometric models and provides insight into the future. What these models tell us is that many hazards lie ahead for the U.S. economy and the lumber industry, any one of which could easily derail the fragile recovery. At the same time, any one of these obstacles could be removed, leading to better outcomes. During the last part of 2010, we saw obstacles being removed from the economy.

As a result, the outlook for the next 24 months looks better than it did just a few months ago. GDP growth is stronger. The number of starts is increasing. Unemployment numbers are improving. Even during the second leg of the recession, negative GDP growth will not be as severe as we once thought. All of this supports the view that the worst news is behind us. And who knows? Perhaps the stars will align and the economy will recover even faster.

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