



East Meets West

Outlook for the Timber Industry in the Pacific Northwest

By Gordon Culbertson, Manager of Forest2Market's Pacific Northwest operations

In the winter of 2009, Pacific Northwest timber markets were at their lowest in decades. In response, mills across the Northwest cut production to match demand. While Inland markets remain subdued, heightened demand from China created an export market west of the Cascades, leading to a modest recovery. This interaction between East and West will be vital to the outlook for Northwest timber markets in 2011 and beyond. The health of US economy, the performance of the housing market, and the sustainability of Chinese demand will all play a role in the pace and extent of a recovery going forward.

Forest2Market's forecast for the next 24-months has been steadily improving since mid-2009. Our short-term outlook for GDP growth is positive, and our models show it will remain so through 3Q2011. In part because the new bi-partisan tax law fixed tax rates for the next two years, provided businesses with accelerated depreciation schedules, and reduced social security withholding rates, the length of the second leg of the recession looks less severe. In September 2009, some of our models called for a 17-month contraction; we now expect a 9-month recession.

Despite this second recession, our forecast shows a slow and gradual recovery for the housing industry. The recession has proven that the baseline for starts is roughly 500,000. Foreclosure fraud and lower home prices will bump starts above this baseline, as some homebuyers will choose new homes over existing ones with encumbered titles and lower home prices will entice more buyers to take advantage of low interest rates. For 2011, our forecast calls for 625,000 starts. By 4Q2012, we expect starts will top 800,000 on an annualized basis.

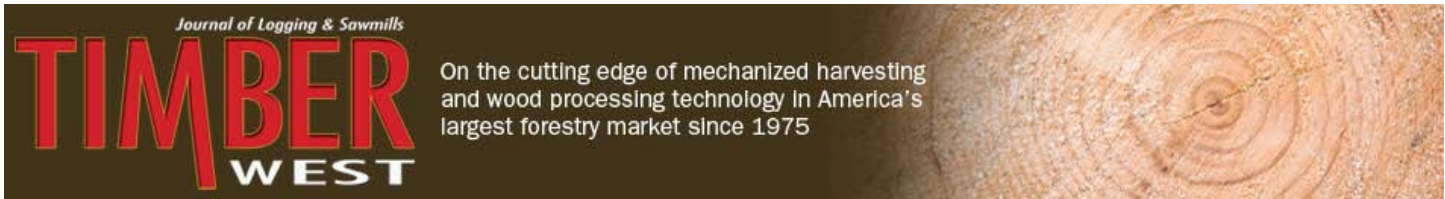
In addition to GDP and housing, the Pacific Northwest forest products industry will be influenced by log and lumber demand from Asia. In 2010, breakbulk log exports to Asia increased by 82 percent over 2009, with 49 percent going to Japan, 44 percent to China and 7 percent to Korea. The big growth story here is China. From 2009 to 2010, exports from Oregon and Washington to China grew by 758 percent. In 2011, we expect exports to repeat or even exceed 2010 levels.

Just how sustainable is China's appetite for US logs?

GDP growth in China grew at a rate of 10.3 percent in 2010, up from 9.2 percent in 2009. While China has a reputation for being able to manage its economy with precision, past experience suggests this rate of expansion can't last. China acknowledged this fact when, in the last quarter of 2010, it raised interest rates and reserve requirements for banks in an attempt to contain their overheated real estate market.

Another supply chain factor may lead to a reversal of the 2010 trend. The introduction of higher Russian tariffs on logs, low freight rates (due to the global recession), and favorably priced US logs (due to the housing market) motivated the Chinese to seek US logs for the first time since the early 1990's. Changes in these factors could cause China to turn to Russia once again.

And changes are likely to occur. Russia is considering a reduction in log tariffs to gain entry into the World Trade Organization. Higher fuel prices are certain in 2011, and this will push freight rates higher. A recovering US housing market will be an increasing source of competition. As these events unfurl, the volume of exports to China may track lower.



What will this mean for log prices in the Pacific Northwest?

Wood supply dynamics tell part of the story. Logs exported to China consist of the Douglas fir and hemlock grades preferred by mills producing building products for the US housing market. As long as demand for US logs grows in China, this competition will drive prices higher and tighten margins for Northwest mills.

Strengthening domestic appetite for lumber and panels will ultimately encourage increased production and timber harvest levels. The shortage of loggers and mill capacity, leftovers from the past recession, will push log prices higher in 2011.

More vigorous export markets for logs and lumber supported the survival of the forest products industry in the Northwest in 2010. In 2011, as pent up demand makes its way back to the market, the industry will find more solid footing. When demand from Asia meets demand from the US, however, logic suggests that buyers requesting shipments to US destinations will prevail over shipments destined for distant ports.

Gordon Culbertson has more than 30 years of experience in the forest products industry in the Pacific Northwest. He has direct hands-on experience at every level of the supply chain — from logger to manager of timber operations to VP of Timber Resources. Currently the Manager of Forest2Market's Pacific Northwest operations, Culbertson is an expert in the Pacific Northwest log and wood fiber supply chain and in emerging markets affecting the forest industry.