

Canada's timber industry awaits US recovery

Canadian producers have turned to other export markets while the US economy suffers, but its neighbour's return to health is eagerly awaited. Peter Woodbridge reports



SUMMARY

- BC Interior mills have maintained production.
- Canadian lumber producers have developed new geographical markets.
- China accounts for nearly two-thirds of Canada's shipments to east Asia.
- Canadian lumber output is likely to be up 2% on a year ago.

Above and left: BC Interior mills have maintained production

With housing starts in the US – Canada's major market – struggling to reach 585,000 units this year, compared with more than two million at the market peak in 2005, Canada's sawmilling industry should be in much worse condition than it actually is today. Lumber prices on the same basis should also be much lower.

There are several reasons for this situation. Most importantly, there is an improved balance between lumber supply and the sharp decline in US demand. Throughout North America, significant levels of manufacturing capacity have been eliminated.

In the three years following the 2005 peak, the North American softwood lumber industry lost close to 15% of its capacity, according to US Forest Service data. With curtailments, the permanent closures have helped surviving mills produce at a tolerable rate of capacity utilisation. Many analysts think that, in part because of a shortage of economically accessible timber, the total loss of capacity on a full-shift basis could be closer to 25% – even at higher log prices.

BC Interior mills have maintained production. They are a special case. They are racing to fell beetle-killed pine timber while it remains merchantable and a lot of lower grade timber has been harvested. With low wood costs, many of the highly efficient sawmills operating in the Interior region of British Columbia and parts of Alberta are running close to full capacity.

Canadian lumber producers have been busy

over many years developing new geographical markets with ongoing punitive trade actions and tariffs imposed by the US against Canadian softwood lumber exports being a strong motivation. Canada has lost market share in the US to American sawmills.

As a result of its market diversification efforts, Canada's softwood lumber exports to east Asian markets in 2011 are expected to be around 11.3 million m³ (nominal 2x4 basis). This is a 250% increase over five years (*Figure A*). In addition, Canada's 2011 record shipments to east Asia compare favourably

with forecast shipments to the US of 20.3 million m³.

In 2011, China will account for nearly two-thirds of Canada's shipments to east Asia – up from 25% just five years ago. For British Columbia, which supplies most of Canada's volume to east Asia, this market area actually purchased slightly more volume than the US in 2011 – for the first time in lumber trade history.

Key to this success has been the rapidly rising demand for lower grades of lumber (#3 grade) from China. Without this market, BC >

Figure A. Canada's market diversification softwood lumber exports to the US and east Asia (Million cubic metres – 2x4 nominal basis)

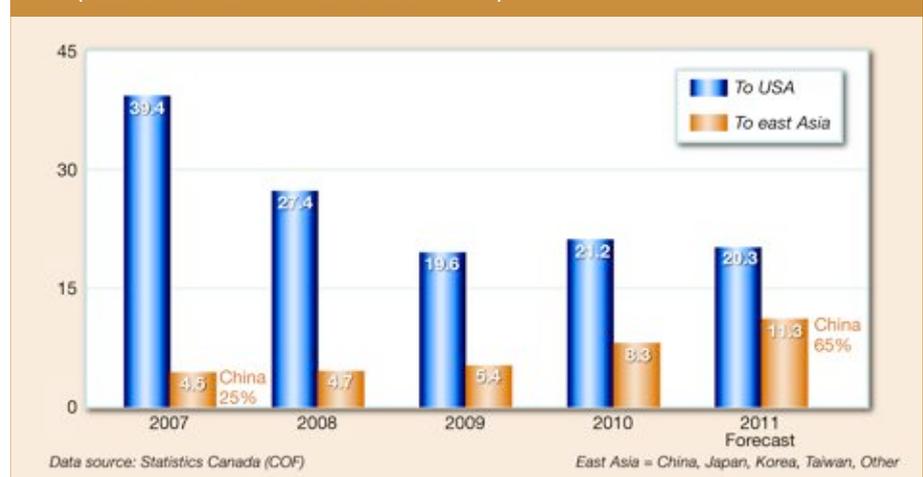
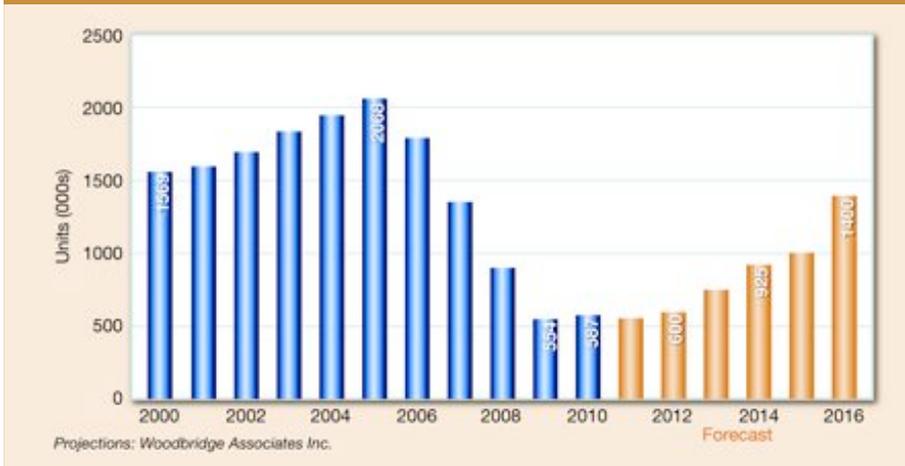


Figure B. US housing starts (All units excluding mobile homes)



◀ Interior mills would not have found a home for all the volume they have been producing. Recovery of production on the BC Coast has been boosted by demand for lower grades of hemlock lumber, which has limited markets in North America.

Overall, the North American lumber manufacturing sector has turned the corner. Taking into account a decline in production in eastern Canada, Canadian lumber output is likely to be up marginally 2% in 2011 over last year – and up by 9% in the US, to an aggregate total of 118 million m³ (on a nominal 2x4 basis).

As a result of significant growth in offshore markets for Canadian logs and lumber, notably in China, one of the side benefits is that the US is no longer the principal price-maker for North American lumber. China's demand for lower grade lumber has become a saviour for western Canadian lumber producers, and this has put upward pressure on prices for higher grades.

The rapid growth of China's appetite for softwood lumber and logs, and the corresponding boost to North American prices, is sometimes referred to as "the China Effect".

Impact of Russian trade

There is no doubt that North America, and other regions, have benefited from seismic shifts in Russia's timber trade with China. As the major global importer of Russian logs, China moved quickly to diversify its supply lines when Russian policy-makers announced a rapid ramp-up of export tariffs.

Although some bilateral tariff reductions have been negotiated with western Europe in exchange for EU support for Russia's bid for WTO membership, it seems unlikely that Russia will revert to log export growth. In addition, significant further growth in Russian sawnwood exports appears limited by capacity, cost and logistical constraints for the immediate future. This is a favourable situation for other parts of the global supply chain, notably log exporters in New Zealand and western North America – and lumber producers in western Canada.

How will Canadian lumber supply and prices play out over the next five years?

Stung by US tariffs, sizeable parts of Canada's sawmilling industry, notably BC, will probably continue to develop diversified offshore markets. But the reality is that the vast US market will recover – and the US market

export volume potential for Canadian mills is many times the offshore market potential. Today's sales volume to the US is low. Encouragingly, it is less than 60% of what the US is expected to buy from Canada by 2015.

Not surprisingly, the US housing market will remain as a drag on North American lumber consumption for several years to come. New housing starts – especially single-family housing units – are unlikely to recover to past high levels. Factors creating a much more downbeat US demand outlook than just a year ago include a moribund mortgage loan industry business model and a huge overhang of foreclosed homes.

America's housing is the most subsidised in the developed world. US subsidies for housing include tax-based incentives (for example, mortgage interest tax deduction, capital gains tax exemptions) and financial subsidies – comprising mortgage credit, insurance and guarantee programmes. The latter are provided by Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac enabling borrowers to obtain 30-year loans at a fixed interest rate.

This business model is broken and historical, artificially-boosted, demand levels simply cannot be sustained.

Worse still, structural downward shifts in demand may be under way. Rapidly declining

rates of home ownership, and a shift into rentals, indicate sharply lowered expectations for the American Dream of homeownership.

We see little to indicate that US new housing demand will recover in 2012 (Figure B). This will improve slowly to better markets by 2013 as the housing inventory overhang is reduced and as the US economy improves, albeit modestly. With a strong Canadian dollar, 2012 profit margins at Canadian sawmills are expected to be squeezed.

A bright spot will be the US home renovation and improvement market. Recovery during 2011 has been held back by the overall macro-economic and housing market malaise. Demand and prices are predicted to recover in late 2012 – and move-up strongly between 2013 and 2015. This is good news for cost-efficient European shippers because North American 'Big Box' markets like 'wane-free' higher grades of lumber produced in western Europe.

Canadian housing market

Canada's domestic market for lumber has benefitted from a very different housing market, and a much more stable mortgage finance market, than exists in the US. In many parts of Canada, house prices have risen over the past few years. Starts levels have been healthy, with a slight hiccup in 2011. In BC, strong demand from Chinese investors has kept prices high in large urban areas. Overall demand for rental and ownership housing seems likely to continue over the next several years, supporting new demand for softwood lumber (Figure C).

The US, Canada, China and Japan are Canada's key lumber markets. A future 'grand slam' recovery in lumber demand with 'all four market bases loaded' is quite possible. The evidence points to it being several years away – we estimate by 2015. If this surge in demand occurs, along with constrained supply, a much-talked-about lumber super-cycle could occur.

The prospects of a super-cycle are encouraging. Even moderately improved US demand would be welcomed. Even so, 2012 is likely to test further lows – especially in eastern Canada – before a broad based recovery can be enjoyed. ■

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Figure C. Canada: Projected housing starts

