Lumber investors recalibrate expectations as supercycle stalls

FOREST VIEW

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Investors in lumber stocks are feeling dismayed at the sector's recent price performance. Confounding bullish expectations, prices are well off their recent highs. Investors must feel like the parents of a super-star high school student who inexplicably is at risk of not graduating.

Analysts are saying that the much-promised prospect of a "lumber supercycle" now looks more distant. Pulp looks vulnerable in the short term. Costs are rising. Mills are starting to take downtime. Have the fundamentals changed? Not really.

Practical realities have restored themselves. Supply and demand are recalibrating at a lower lumber price level. This has pushed supercycle expectations to the sidelines, at least for now.

The lumber supercycle story has been told many times. It's based around a plot of structural declines in global supplies of sawlogs – contrasting with slowly recovering conventional demand and much higher consumption in rapid-growth new markets, such as China.

That's a recipe for rising lumber prices – and potentially much higher profit margins in some producing regions.

The supercycle boost kicks in when traditional markets and new rapid-growth Asian markets are firing on all cylinders simultaneously.

That hasn't happened yet.

It's important to understand the supply-side story. B.C.'s pine beetle infestation and its impacts play a key role. With so many dead trees, most of them unusable for structural lumber purposes, the B.C. Interior region's softwood lumber output is predicted to plunge. Harvests are declining too in other parts of Canada.

Why is B.C. so important? In years past, B.C.'s lumber has accounted for one in five new housing starts in the U.S. Overall, Canada has a 30% share of total supply into the U.S. market in normal times. That's likely to decline sharply.

It's not just Canada's impending decline as the major powerhouse in global lumber supply that's influential. The other side of the story is that the U.S. has looked to Canada to supply much of its domestic supply shortfall. That's not going to be possible in future cycles. This is unprecedented – and it means money for some.

B.C. firms such as **West Fraser**, **Canfor** and **Interfor** have invested substantially in buying U.S. sawmills, notably in faster-growing plantation timber in the south. Consequently, although the B.C. Interior sawmilling industry's lumber production will decline, investors in these firms will continue to enjoy a high market share. Overall, North American lumber output will grow in the long term, but at a much slower rate.

Because they're the most technologically sophisticated and efficient lumbermen worldwide, B.C. sawmill managers are creating significant productivity – and potential earnings – gains in their U.S. acquisitions.

There are several other players in the declining growth of supply globally. Russia has a policy of diverting its plentiful supply of virgin timber, formerly exported, into domestic manufacturing. Some of that is happening already, and there is more to come.

Other traditional export supply areas are running out of sawlogs. Overall, most suppliers can't grow to meet the demand. The result is a very rapid – and unprecedented – reduced rate of global timber supply growth.

Asia – China in particular – is chronically short of commercial timber and wood fibre.

In explaining why lumber stock prices have fallen so quickly recently, it's clear that Canadian lumber supply is the villain in the story. Unlike the pulp industry, which practises supply management, B.C. lumber producers prefer to keep their mills operating at high rates – even when demand softens, as it has at the moment.

They have been aided and abetted by the declining value of the Canadian dollar in U.S. funds. Softwood lumber is sold in U.S. dollars. So B.C.'s mills shipping to the U.S. recently have made a windfall gain of around 20% on their export sales.

Supply management exists in the lumber industry, but it's imposed on Canada by the Americans, who want to protect their less efficient, domestically owned sawmills. The 2006 Softwood Lumber Agreement is expiring in October and might be replaced by something more onerous.

Import demand for B.C. lumber in China's formerly hot markets is experiencing a temporary, but significant, pause in growth. This reflects China's slowing economic growth, uncertainties in the Chinese housing market and credit restrictions. In the meantime, there has been a significant backwash of China-destined lumber into North America.

And it doesn't appear that U.S. markets will recover quickly enough to absorb the super-saturated supply.

Thus far in 2015, U.S. lumber markets are failing to impress.

Underlying the slow recovery of all U.S. housing markets are two overriding factors. The U.S. mortgage finance market is still not functioning properly – and potential first-time buyers are not yet confident and willing to commit to the shift from renting to home ownership.

The biggest potential home-buying cohort – the millennials – are sitting on the sidelines. This is a huge group. There are 76 million baby boomers but more than 87 million millennials in the U.S. Without doubt, they are defining today's housing markets. Until they become active buyers and shift their preference into living in single-family homes, U.S. housing starts will continue to languish. Short term, it will be difficult to balance lumber demand growth with supply.

Like the hapless parents of the underperforming high school superstar, reining in some extracurricular activities could help the situation. The analogy in this case is that, for softwood lumber prices to rise meaningfully, Canada's lumber industry will have to reduce its current overproduction.

In the meantime, investors' recalibration of Canadian lumber stock values seems justified and prudent. ■

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