

First Quarter 2018 Economic Commentary and Timber Market Conditions

Growth continues to improve, modest uptick in timber prices for most products

Economy

Economic growth continues to improve. The third GDP revision for fourth quarter came in at 2.9%, exceeding the 2.5% estimate from last month, and not far from the 3.2% third quarter figure. Much of the gain came from a sharp uptick in consumer spending, but fixed residential and non-residential investment also contributed significantly. Both inventories and net exports were drags on growth.

We remain convinced that GDP will rise further over at least the next several quarters. The impact of the major fiscal stimulus, in the form of tax cuts and increased government spending, have yet to be absorbed by the economy. By next quarter we believe GDP will exceed 3%. Corollary benefits are in the form of rising employment and wages.

On the subject of employment, the March payroll figure rose by just 103,000 jobs, far below the upwardly revised 326,000 of a month earlier. However, much of the reversal was weather related, with the retail and construction sectors facing the largest drops. In contrast to the monthly figure, which can be quite volatile, the three-month moving average payroll number showed a gain of 202,000. The labor force participation rate also rose slightly from three months earlier, to 62.9% versus 62.7%.

As the economy approaches its long-term potential growth rate a rise in inflation is

expected. Inflation rises as hiring picks up, which puts upward pressure on wages; moreover, as consumers spend more it puts more money into circulation; finally, as businesses invest more, it pushes up interest rates. To date, changes in the CPI are modest, albeit with increased volatility in recent months. In February, the CPI rose an unremarkable 0.2% following an unexpectedly high 0.5% increase in January. For the past year, inflation has advanced just 2.3%. That said, as growth accelerates, we expect inflation to also advance more quickly, especially when wages rise in a meaningful way.

In an effort to constrain potential inflationary pressures, the Federal Reserve continues to raise short-term interest rates, and appears to be getting increasingly hawkish. In March, the Fed raised the target federal funds rate by 25 basis points, from 1.50% to 1.75%, a move that was widely anticipated. The Fed maintains its position that there will be three rate hikes in 2018. Longer-term rates are also rising. The 10-year treasury, currently hovering around 2.8%, is up from 2.54% three months ago and 2.34% a year ago. The current level is the highest since early 2014.

The manufacturing sector continues to exhibit strength. In March, the ISM Manufacturing Index, an indicator of manufacturing activity, came in at 59.3%, down slightly from 60.8% a month earlier, but the same level as three months ago. The ISM has witnessed an upward

trend since mid-2016. The ISM is a diffusion measure, with values above 50% signaling growth and below 50% indicating contraction. The current level indicates that manufacturing continues to rise at a faster pace.

The housing market slipped slightly in February. Starts came in at 1.236 million, versus 1.299 three months earlier, a 4.8% decline. However, most of the drop was in multifamily starts rather than single-family. Year-to-year, single family starts rose 2.9% versus a decline of 19.1% for multifamily. Positively, this suggests that the market for single-family homes, which utilize more lumber per square foot built than multifamily, continues to recover.

Permits, which help predict future construction trends, were almost unchanged from three months earlier, at -0.4%. For the year, however, they were up 3% from a year-ago. February new home sales were off -13.1% from three months ago, but virtually unchanged from a year ago (+0.5%).

Existing home sales were reported at 5.54 million units in February, a -3.1% change from three months earlier. The most significant decline was in the Northeast, which saw a fall of -12.3%. The Midwest saw a -2.4% fall. Both of those regions also experienced a protracted and harsh winter weather for the past several months. In contrast, the South and West saw existing home sales rise 6.6% and 11.4%, respectively, over the quarter.

Forest Product Markets

At the end of March, the Random Lengths Lumber Composite Price stood at \$492, up 8.6% from three months earlier and 18.8% from a year earlier. During the same time frame, the RL Structural Panel Composite, at \$532, rose 17.7% for the quarter and a dramatic 29.8% year-to-year.

In softwood-producing regions outside the South, the rise in lumber prices correlates

closely to log costs, which are a function of log availability. Random Lengths Yardstick¹ reports that the price of Douglas-fir logs has risen “at least 25% from a year ago.” Other log species in the West are up more than 20% from year-ago levels. In the U.S. Pacific Northwest and British Columbia in Canada, this is attributed to a wet spring in 2017 that was followed by a record fire season. The combined impact was to hamper logging and transportation operations, which drove up raw material prices.

Bleached Softwood Kraft Pulp (BSK), a bellwether of the state of the pulp and paper market, was \$1097.06/metric ton at the end of March, up 9.4% from a quarter earlier and 31.7% a year ago. The most recent level is a record high. Moreover, since the beginning of 2018 the record high has been broken in each of the last 12 consecutive weeks. BSK includes Northern and Southern Softwood Bleached Kraft Pulp (NBSK and SBSK).

Bleached Hardwood Kraft Pulp (BHKP), a proxy of the strength of the market for printing and writing papers, was \$1031.03/metric ton, a 5.0% gain from three months earlier and 41.4% from a year earlier. The current BHK price also reflects a record high. Beginning last October, BHK prices have continued to outpace the previous all-time high of \$920/mt seen in 2010.

Timber Market Conditions

Housing, exports, lumber and panel prices all have an influence timber on prices. Over the long-run, rising (falling) housing markets push lumber prices up (down), which in turn drives rising (falling) timber prices. In the short-term, however, the relationship can be clouded by local market conditions. These include abnormally wet or dry weather, mill startups and shutdowns, maintenance closures and the availability of a trained logging force.

These relationships can be obscured over longer periods by factors that include an overhang of available timber. This is the situation that

southern markets have been grappling with over the last few years. Although housing is trending upward, and despite high lumber prices, the Great Recession and its aftermath left a substantial volume of sawtimber-size trees as standing inventory. Positively, those trees continued to grow biologically, which adds value due to incremental volume growth. But it also means that despite increased timber demand, a greater volume must be worked through.

That said, however, Q1 2018 saw price gains for most solid wood products. Southwide pine sawtimber prices rose 1.53% for the quarter. For the year they were up 0.8%. Small diameter sawtimber (chip-and-saw) was up 3.8% for the quarter and 1.5% year-to-year. Hardwood sawtimber was unchanged for the quarter, and off -0.2% for the year. The strong gains in hardwood sawtimber over the past several years means that its current southwide average is still well above its long-term trend.

After a fairly strong gain in Q4 2017 (3.4%), pine pulpwood witnessed a slight decline of -0.7%.

For the year, pine pulpwood prices were unchanged. Hardwood pulpwood, in contrast was up a strong 11.9% for the quarter, and 16.2% year-to-year. The gain in hardwood pulpwood is at least partially explainable by higher than average rainfall in much of the South.

Last quarter we forecast that Southern pine sawtimber would see gains in first and possibly second quarters as the building season picks up. Although the price changes to date are modest, our first quarter prediction was nonetheless borne out. In second quarter, as homebuilding hits its stride, and given the very high prices now observed for western sawtimber, we see further gains ahead for Southern pine. If interest rates do not rise dramatically, sawtimber price gains have the potential to be significant. The possibility also exists for gains in pine and hardwood pulpwood prices coming from the sustained rise in pulp prices.

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ⁱ Random Lengths Yardstick, February 2018 28(2), p. 1.