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## 2017: Good Signs in Wood Products

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Market participants in the North American wood products market are once again cautiously optimistic as they look to 2017. This caution continues to pervade the wood products markets as uncertainty from the ongoing softwood lumber trade negotiations between the USA and Canada, the uneven U.S. housing recovery and the potential for further OSB restarts stifle optimism.

Market participants seem to be gearing up for what they believe will be yet another year of modest demand growth with ample supply availability. This will likely result in cautious inventory buying behavior early in the year. However, 2017 could easily surpass these cautious expectations, which could result in an insufficient inventory buffer as demand powers higher both cyclically and seasonally in late spring and throughout the summer.

Buyers adopted a conservative inventory strategy in 2016 in response to recent market performance and restrained expectations. Unmet price expectations in the North American OSB market in 2013 and more recently in the softwood lumber market in 2015 translated into debilitating inventory losses.

Fresh memories of inventory losses combined with guarded optimism about housing (traders fully in the show-me mode), the OSB industry still acclimating to the startup of over 4.5 BSF of OSB capacity, and the uncertainty surrounding the outcome of the softwood lumber trade negotiations between the USA and Canada drained enthusiasm for building inventories in 2016.

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Consequently, as demand moved both seasonally and cyclically higher throughout the year, buyers were forced to keep the frequency of ordering elevated to meet final demand, driving prices higher in a relatively orderly fashion through much of the year. This allowed producers to generate solid cash flow, and the conservative inventory strategy proved successful as buyers were able to acquire wood on an as-needed basis.

Many industry participants are planning for another year of modest demand growth in 2017. U.S. housing starts have yet to consistently break out above the elusive 1.2 million unit mark. In fact, the two times they surpassed that watermark between January and September 2016, they fell below it the following month.

At the time of submitting this article it remains to be seen what happens after October's eye popping 1.32 million housing starts. Despite healthy demand, U.S. housing production has been held back by the supply-side constraints of labor and land availability. At this point, the show me mentality of traders with regard to the housing markets has kept the consensus forecast at a mild 8% increase to 1.26 million units in 2017, according to forecasts compiled by the APA.

In addition to expectations for modest demand growth, overall uncertainty has been on the rise in recent months. From the potential trade, financial and immigration policy changes under the incoming Trump Administration to the unsettled softwood lumber trade negotiations, rising mortgage interest rates, new OSB capacity and mill restarts, and the strong dollar, to name a few, there is plenty to keep the wood markets unsettled. In this environment, traders are likely to maintain their conservative inventory buying strategies and producers are likely to plan conservatively and hope to be surprised on the upside.

Although many hold conservative views on the wood products markets for 2017, reasons for optimism are growing.

On the demand side, household formations (demand for shelter) remain strong and averaged more than 1.17 million through third quarter of 2016. While this is down from the 1.9 million households formed in 2015, it is on pace with underlying demographics and demand fundamentals.

The owner-occupied segment of household formations is up from only 33,000 units in 2015 to an average of 414,000 units year-to-date in 2016. The strength in the owner-occupied segment of household formations has been mirrored somewhat in housing starts, where single-family starts have averaged 778,000 units through October, up 11% from 2015.

The resurgence in single-family starts bodes well for wood products consumption as single-family homes are nearly double the size and consume three times the wood on average as a multifamily unit. Demand for shelter should remain strong in 2017, supported by continued gains in employment, wages and consumer sentiment. With shelter inventory extremely tight, this demand will put increasing pressure on the existing shelter stock, which should eventually translate to increased residential construction as the supply-side constraints of labor and land eventually ease.

The U.S. residential construction market garners most of the attention, but the residential repair and remodeling market is the largest end-use market for softwood lumber and the second-largest for OSB in the USA and therefore deserves serious consideration in any wood products outlook. In the absence of a

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notable increase in residential construction, demand pressure will continue to push home price appreciation well above underlying inflation and wages.

A tight shelter market and escalating home prices will remain a boon for the residential repair and remodeling market as potential trade-up buyers make the decision to add-on in lieu of trading up. This will drive wood consumption in this end-use market higher as not only will the total expenditures in this end-use market increase, but the wood usage per dollar spent on these major alterations and additions tends to be more wood intensive.

On the supply side, lumber and OSB may not be as readily available throughout 2017 as they were in 2016. The increase in Canadian softwood lumber production and shipments to the USA in 2016 will be difficult to maintain in 2017.

Lumber producers in British Columbia are already starting feel the pinch from limited fiber supply due to the mountain pine beetle, and simply maintaining the 2016 production gains in 2017 will be challenging.

Meanwhile, producers in Quebec and Ontario will have to address the challenges of lackluster demand for residual fiber and the cost of accessing the additional timber available in the region to increase production in 2017.

Furthermore, the impact that potential duties or quotas would have on Canadian shipments to the USA needs to be considered. Supply from offshore markets helped buffer the North American softwood lumber market as demand improved cyclically in 2016. Offshore imports ratcheted higher in response to the strong U.S. dollar, rising domestic demand and strong prices, but still only accounted for an estimated 2% of demand compared to an apex of 4% during the previous peak in 2005.

This source of supply is likely to rise again in 2017, but will remain relatively small on a volume basis. Finally, with U.S. western lumber production likely to improve only incrementally due to the elevated cost of timber, the key to the supply/ demand balance in 2017 will be the rate at which lumber production in the US South expands.

Meanwhile, the OSB industry is finally approaching the point of full utilization of the 4.5 BSF of capacity that was restarted earlier in the recovery. Stronger market fundamentals have engendered plans for further capacity expansion in the OSB market with three potential mill restarts at Huber's Spring City, Tn., mill, Norbord's Huguley, Al., mill and Tolko's High Prairie, Alberta, mill as well as the first greenfield mill the market has seen in years, Martco's Corrigan, Tx., mill. The Texas project is not slated to start producing OSB until the third quarter of 2017 and Huber's restart not until 2018 with potential startup timelines for the Norbord mill and Tolko mill yet to be determined, but the anticipation of additional capacity seems to already be influencing market behavior heading into early 2017.

However, this new capacity will not have a material effect on the supply/demand balance in the market next year as any additional supply from the planned capacity additions will not be available to the market until after demand reaches peak seasonal levels in third quarter 2017.

It is easy to understand why many market participants are cautiously optimistic about the North American wood products market in 2017. The slow recovery in U.S. housing starts that is now going into



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its eighth year, the unresolved softwood lumber trade negotiations and potential duties levied on Canadian shipments to the USA, the uncertainty surrounding the policy goals of the incoming Trump Administration, recent inventory corrections in both lumber (2015) and OSB (2013), and readily available supply throughout 2016 have resulted in a flashing yellow light for the wood products market heading into 2017.

These factors may dampen market expectations, but not necessarily final demand. RISI remains optimistic and expects demand for wood products to improve and outpace supply gains in 2017. In this scenario, modest inventory strategies implemented early in the year coupled with conservative production plans could result an insufficient inventory buffer, forcing both buyers and producers to chase the market higher as demand approaches peak seasonal levels during the second half of the year.

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