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Second Quarter 2017 Economic Commentary and Timber Market Conditions

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Richard P. Vlosky, Ph.D.
Director, Louisiana Forest Products Development Center
Crosby Land & Resources Endowed Professor of Forest Sector Business Development
Room 227, School of Renewable Natural Resources
Louisiana State University, Baton Rouge, LA 70803
Phone (office): (225) 578-4527; Fax: (225) 578-4251; Mobile Phone: (225) 223-1931
Web Site: www.LFPDC.lsu.edu

President, Forest Products Society; President, WoodEMA i.a.

Argent TIMBERLAND GROUP
A Division of Argent Trust Company

600 University Park Place
Suite 300
Homewood, AL 35209

205.730.5100
ArgentTimber.com

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Steadily improving economy and timber prices moving toward trend

Economy

To say that the first six months of the Trump presidency has been 'interesting' is like saying that Frank Sinatra was a singer. In recent months the country has witnessed battles between the administration and: the beltway media; the 9th Circuit Court of Appeals; various members of Congress; a former FBI Director; Clinton supporters; and most recently, many G-20 leaders.

That said, the new president continues to pursue implementing the promises he made during his campaign. For example, he has signed 13 Congressional Review Acts to eliminate regulations thought to be unnecessary. In doing so, he has rolled back more regulations than any President in history, according to the *Wall Street Journal*.

The President has met with heads of state that include Russia's Vladimir Putin, China's Xi Jinping, Mexico's Enrique Peña Nieto and Israel's Benjamin Netanyahu to discuss a variety of subjects of shared national interest. These range from trade (China), border security (Mexico), the fight against terrorism (Israel) the existential threat of North Korea (China), and the Syrian civil war (Russia). While stark differences may exist between the U.S. and other nations on many of these issues, at least they are being put on the table.

Most recently the President met with leaders of the G-20 nations, who mostly voiced their displeasure with the U.S. decision to pull out of the Paris Climate Accord, an agreement signed by the previous President but never ratified by Congress. Mr. Trump's view is that the agreement would lead to an expensive mandate on climate policy, with little or no positive result.

While attending the G-20 the President had a positive discussion with UK Prime Minister May on the subject of a post-Brexit trade agreement. Trade between the two countries is currently worth about $230 billion annually, and the U.S. is the largest single source of inward investment into the UK. Potential exists for making trade between the two nations significantly larger.

Also, immediately prior to the writing of this commentary, President Trump delivered a speech in Warsaw, Poland defending western values and civilization. The speech also underscored a prior admonition by the President that most NATO members do not meet their 2% of GDP spending obligation to the alliance.

We expect the next six months to be equally interesting.

The economy continues to improve, but some indicators are more positive than others. The third and final revision for first quarter GDP came in at 1.4%, slightly higher than the second estimate (1.2%) but well below the initial print of 2.1%. Growth was constrained by a downturn in private inventory investment, lower state and local government spending, and an increase in imports (imports are a subtraction from growth). On the plus side, exports rose.

Positively, June non-farm payrolls came in at 222,000, well above the expectation of 179,000, as well as the 180,000 monthly average since the beginning of the year. The jobless rate was at 4.4%, down slightly from three months ago. The average workweek rose 0.1 hour to 40.8 hours.

In May, the Consumer Price Index rose 1.9% from a year earlier. Although below the 2.8% pace observed three months ago, it is well above the rate of the last 2 years. Strengthening payrolls, falling unemployment and a higher inflation all point to the Fed's decision to raise the Federal Funds target rate to 1.25% in June, its highest level since September 2008. We believe the Fed will raise rates at least once and probably two more times by the end of the year.

Our view is supported by other indicators. The 10-year Treasury, at 2.33%, is at its highest level in two months. Outside the U.S. government bond yields have risen even faster – albeit from much lower levels. The German 10-year bond more than doubled over the past few weeks from 0.25% to 0.58%, its highest level in 18 months; in Japan bond yields are at a 5-month high and in France they are at a 7-month high. In short, there seems to be a growing global consensus for faster economic growth going forward.

The housing market is improving but the change remains gradual. May housing starts were 1.092 million versus 1.288 three months earlier. But starts are nonetheless 54% higher than they were five years ago. New home sales performed better, at an annual pace of 696,000 units in May up 9.4% from a year ago. Existing home sales, at 555,000 units were almost 6% above year-ago levels. Sales are being supported by low mortgage rates, with the 30-year recently at 3.96%.

Manufacturing is gaining momentum. In June, the ISM Manufacturing Index, an indicator of manufacturing activity, rose to 57.8%, versus 54.6% in May. It is up from 52.3% a year ago. The ISM is a diffusion measure, with values above 50% signaling growth and below 50% indicating contraction. The most recent reading indicates that the pace of manufacturing is rising.

Forest Product Markets

At the end of 2Q2017, the Random Lengths Lumber Composite Price was $397, up 1.0% from three months earlier and 14.4% from a year ago. Over the same period the RL Structural Panel Composite stood at $403, a 4.4% increase for the quarter and 10.8% for the year. The Composite Panel price includes both plywood and oriented strand board (OSB), with the latter playing a much more important role in homebuilding. The RL OSB Composite rose 29.4% over the year, to $363, while the plywood composite was unchanged at $512. With the exception of the latter, all of these are positive indicators. If the housing recovery continues, which we believe it will, the expectation is for robust lumber pricing to continue.

However, part of the price rise in recent months comes from the U.S. Department of Commerce imposition of Countervailing Duties (CVD) in late April, which average 20% on Canadian lumber shipped to the U.S. This was followed in late June by the additional imposition of anti-dumping duties averaging 6.87%. These tariffs follow the expiration of the US-Canada Softwood Lumber Agreement at the end of 2015. Lumber shipments from Canada to the US were 16.1 billion board feet in 2016, the highest pace since 2007. The imposition of the CVD and AD duties are likely to spur negotiators from both sides to the bargaining table to work out a new Agreement.

The price of Bleached Softwood Kraft Pulp (BSK) a bellwether of the pulp and paper sector, was $889.82/metric ton at the end of June, a 6.8% gain from three months earlier and up 10.0% from a year ago. BSK includes Northern and Southern Softwood Bleached Kraft pulp (NBSK and SBSK). Bleached Hardwood Kraft Pulp (BHKP), which reflects the strength of the market for printing and writing paper, was $832.43/mt, a 14.2% increase from three months earlier and a 22.6% rise from a year ago. BHKP has risen sharply in recent months and is currently at its highest level in over five years.

Timber Market Conditions

Housing, exports, lumber and panel prices all influence timber prices. Over the long-term, rising (falling) housing markets push lumber prices up (down), which in turn drives rising (falling) timber prices. In the short-term, however, this relationship is often obscured because price movements are heavily influenced by local market conditions. These can include abnormally wet or dry weather, mill startups or shutdowns, maintenance closures or the availability of a well-trained logging force.

The relationship can also be clouded by an overhang of available timber, which is today's situation. The South experienced an abnormally wet spring and is currently in the midst of an equally wet summer. Normally these conditions would prompt a rise in timber prices as logging conditions became more difficult. But that has not occurred.

This is because an oversupply condition exists in sawtimber markets. Although the housing recovery continues, the sharp decrease in timber demand that prevailed during the years of the Great Recession means that a significant volumes of sawtimber-size trees were left unharvested and continued to grow biologically. Although timber demand has risen over the last several years, a substantial volume of harvestable inventory is still in the process of being worked off.

During 2Q2017 Southwide pine sawtimber prices fell -1.4% from the prior quarter to an average of $23.41/ton. For the year they were off -6.2%. Chip-and-saw (small diameter sawtimber) dropped -5.8% for the quarter and -3.4% for the year. Mixed hardwood sawtimber was off -5.3% in the quarter and -8.5% for the year. In the case of hardwoods, the decline is less the result of an oversupply than it is of overheated demand from Asia earlier in the decade. This led to dramatic price increases that are only now moderating back to longer-term trend levels.

Pine pulpwood prices declined -3.7% in second quarter and -10.6% for the year. Hardwood pulpwood was off -2.5% for the quarter and -18.5% for the year. For both pine and hardwood pulpwood the situation is similar to that of hardwood sawtimber. During 2016 pulpwood prices were up sharply, so at one level the decline reflects a move back towards long-term trend. In the case of pine pulpwood, the decline is also partly a function of the wide availability of pine sawtimber. More sawtimber implies rising lumber supplies, which leads to more pine chip production, as chips are a by-product of lumber mills. The chips are used as furnish by pulp mills, biomass facilities and OSB plants, putting downward pressure on roundwood pulpwood prices.

We have moderated our short-term view of sawtimber pricing, which we expect to slightly increase going forward this year. The potential for a price increase comes from an anticipated slowdown in Canadian lumber supplies due to the recently imposed CVD and AD penalties discussed earlier. Also, Canada is in the midst of a very active fire season which has the potential to disrupt lumber supplies even further. Overall we believe the fundamental drivers point to modest but steady timber price improvements over the next several quarters.

Prepared for Argent Timberland Group by:
Jon P. Caulfield, PhD – President, Timberland Fiduciary Research, Athens, GA

For more information about the commentary found in this newsletter, please contact a member of ATG:

Jim Webb	jwebb@argenttimber.com
Michael Shearer	mshearer@argenttimber.com
Charlie Daniel	cdaniel@argenttimber.com