Lumber: Making Board Level Decisions

Mark Twain's admonition about lies, damn lies, and statistics still applies to much of the output of Washington's numbers mills. Despite the best efforts of Wall Street's economists and sorcerer-wannabes, the connections between economic reports and market reactions remain tenuous.

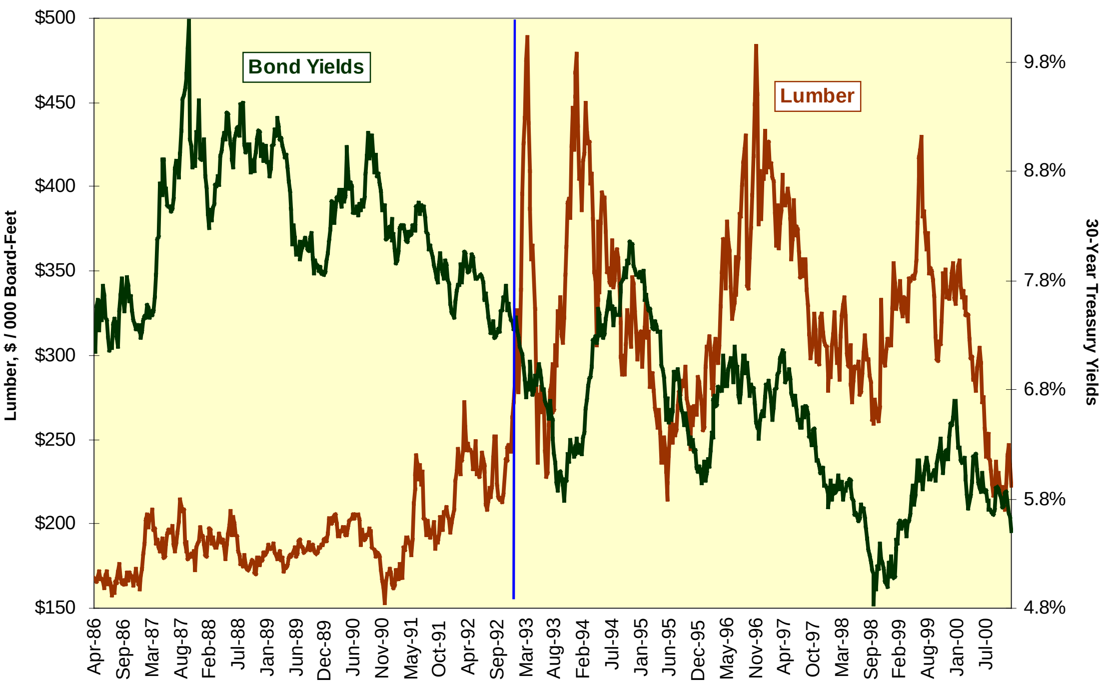
Certain markets, however, have a certain immediacy in their ability to measure economic conditions. Lumber and oriented strand board (OSB, the successor to the plywood of your youth) are defined by the state of the housing market, which in turn is affected by both interest rates, population growth, and the growth of income. Lumber even has an international trade aspect; Canada is a major exporter of all forest products to the United States, and the market is rocked frequently by never-ending disputes over tariffs, quotas, and other impediments to free trade. Good thing we have NAFTA.

The trading and investment implications of these commodity prices will hit us, quite literally, where we live.

The Spotted Owl: Hoo's On First

The 1993 court decision to ban logging in certain old growth forests in the Pacific Northwest to protect the spotted owl was one of our first clues as to how much fun the incoming Clinton administration would be. Prices for stud lumber futures shot from $228 per 1,000 board-feet at the end of October 1992 to $493 by the end of March 1993. Not only did this jump in lumber prices add $7,000 to the price of an average new house by some estimates, it negated much of the fall in mortgage rates over this same period.

Boards And Bonds: A Complex Relationship



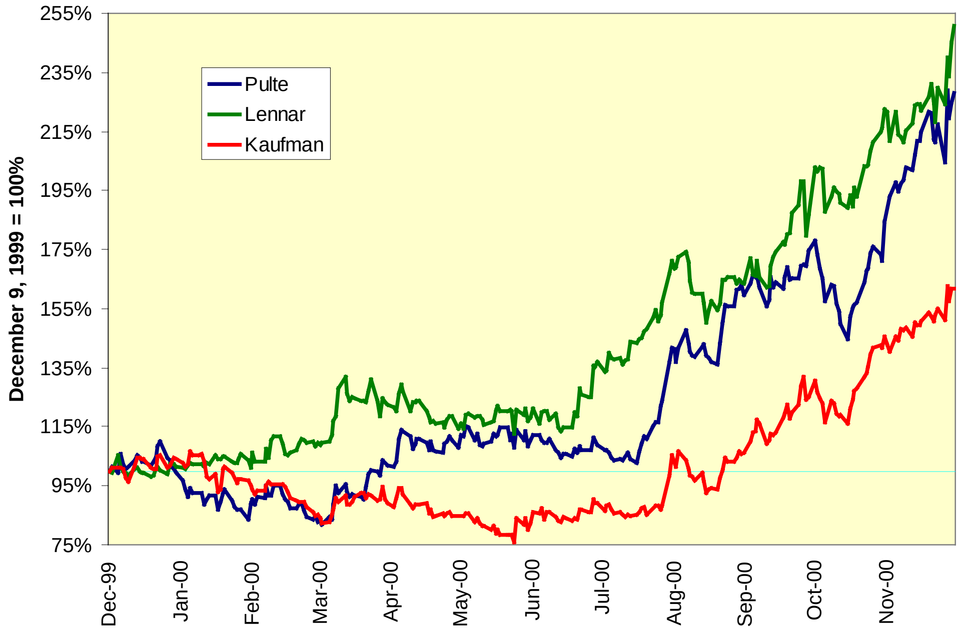
The combination of Canadian export restrictions and U.S. spotted owl protections made lumber one of the few exceptions to the rule often cited here that real commodity prices decline over time. As U.S. housing boomed in the 1990s under a combination of a strong economy and generally declining bond yields, demand for lumber simply outstripped the ability to supply it. After all, a tree takes time to grow, and that delays the supply response we should expect to higher prices. Moreover, despite some well publicized attempts to replace lumber with steel frames or other structural supports, both home builders and buyers wanted to stick with wood, and that limited a normal substitution response.

A Relationship To Build On

Prior to the highlighted spotted owl decision, bond yields and lumber prices had a generally inverse relationship; we can deduce that lower interest rates stimulated housing demand. After the spotted owl decision, a complex lead/lag relationship has emerged. The present environment is witnessing both a decline in bond yields and a decline in lumber prices. Together, these should combine to increase housing affordability. Indeed, the slowdown in national single-family housing starts, which peaked in this cycle in December 1999 at a seasonally adjusted annual rate of 1.441 million, has stabilized at just over 1.22 million in the August-October 2000 period.

Do we see this in the share prices of homebuilders? The industry is not particularly consolidated and has no representative index, but we can take three representative builders, Kaufman & Broad, Lennar Corporation, and Pulte Homes and see how their share prices have been reacting to the widespread concerns over an impending economic slowdown.

Moving On Up: Performance Of Selected Homebuilders Relative To S&P 500



In a nutshell, very well. Both lumber prices and bond yields peaked this year in late January - early February, and the Fed ended its credit tightening cycle – but not its hawkish rhetoric – in late May. Lennar Corporation started to outperform the broad market in January and Pulte in early May. Even Kaufman & Broad bottomed at the last rate hike and has since joined the others as a superior investment. How superior? On a year-to-date basis, Lennar has returned 133%, Pulte 93%, and Kaufman & Broad 43%. Reverse those numbers and you've got yourself a dot-com, 1999-style.

Home Sweet Home?

Well, there are only two ways to make money, going with the trend and going against it. The price of lumber has fallen to its post-spotted owl low, and long-term interest rates already reflect concerns over an economic slowdown and a relaxation of monetary policy. A further decline in lumber prices will prompt loggers to leave the trees standing, and a further economic slowdown will start to cut into housing starts as rapidly as it will push interest rates lower.

We can conclude, therefore, that the days of strong outperformance by homebuilders likely are over for this stage of the cycle. Even with their quite modest forward-looking P/Es – 10.8 for Lennar, 8.8 for Pulte, and 8.4 for Kaufman & Broad – the potential for this industry to grow without exerting cost pressures on its margins is low. What a shame for a beloved and necessary basic industry.

The more venturesome among you may wonder about taking the plunge into lumber futures. The contract suffers from limited liquidity and relatively high execution costs, but it does have some well-behaved technical qualities and trades off both its own fundamentals and those of financial markets fairly well. Anyone who has ridden tech stocks up and down can certainly handle a few 2 x 4's, and may even have some interesting uses therefor.