Getting Teased By Lumber

"This is the forest primeval." – Henry Wadsworth Longfellow

Longfellow might have been the poetic sort, but all evidence suggests he would not have fallen for various "alternative investment" detours such as timberland. People have been cutting down trees, originally as much for firewood as for construction material and certainly well before paper products became a major industry, since time immemorial, but no one was daft enough to consider it a diversifying investment until recently.

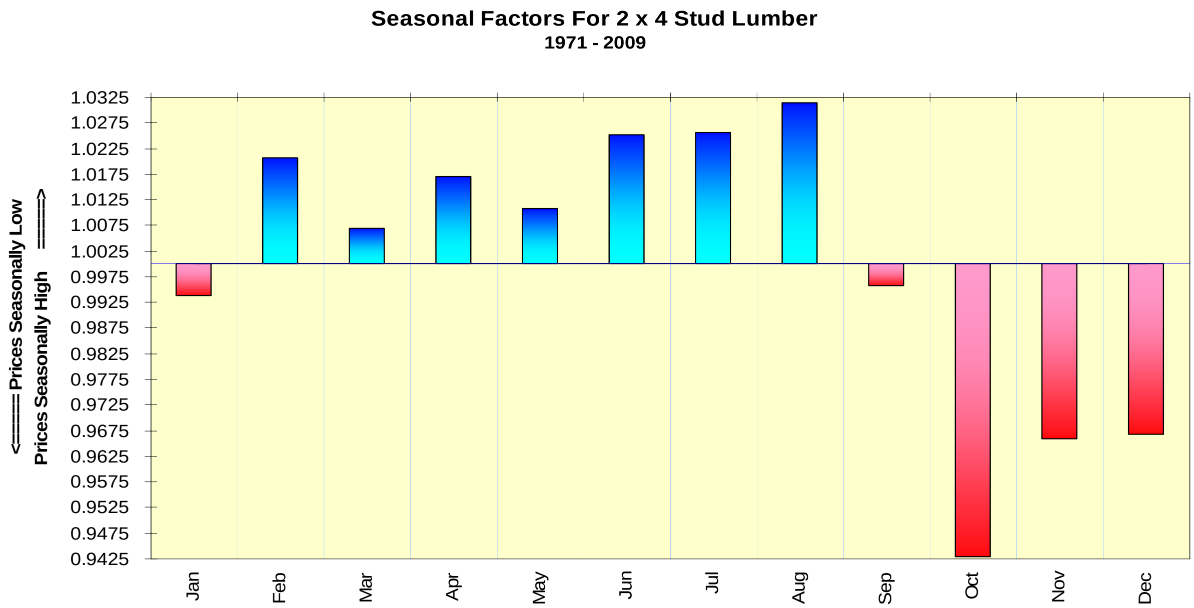
As firewood and charcoal are relatively minor markets in this country and paper products are unrelated to stud lumber and oriented strand board (OSB; essentially what used to be called plywood), we can and should link lumber prices to housing on the demand side. The supply side has had some spectacularly non-economic disruptions over the past two decades, most notably the spotted owl-induced closure of various old growth forests in the Pacific Northwest and a never-ending series of trade disputes with Canada, our NAFTA partner, as part of the Softwood Lumber Agreement.

The recent jump in lumber prices has garnered some attention; as well it might given this market's link to housing. I suppose in a world where everyone wants housing starts to ramp up quickly to solve the excess supply overhanging the market (bizarrely true, isn't it?), any uptick in lumber futures prices is seen as a light at the end of the tunnel. A better explanation may be the timber industry has closed down enough immediate production capacity to make short-term delivery difficult; any small increase in orders will have an immediate effect on prices until capacity is brought back on stream.

The Forward Curve

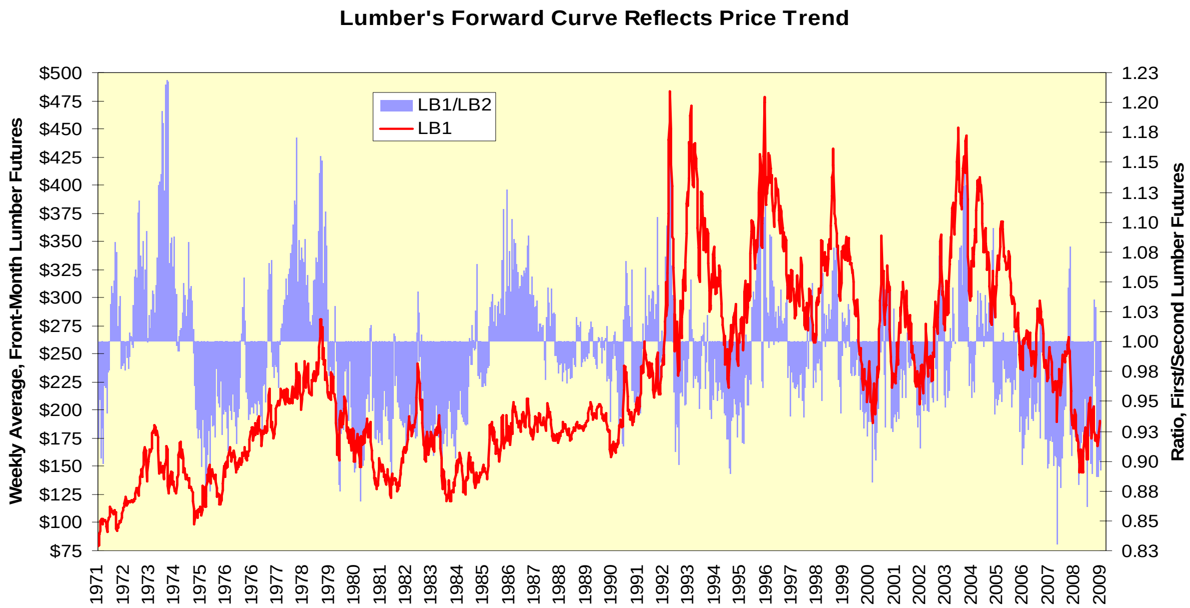
I wrote a column in January 2007 entitled, "Housing Faces Three More Hard Years," which relied on the forward curve of lumber in its analysis. Let's update that analysis in light of the intervening catastrophes and see what signals exist today.

First, the lumber market is strongly seasonal. If we run a seasonal adjustment analysis for 2" x 4" spruce-pine-fir stud lumber, the mainstay of housing construction, we see the fourth quarter should be the weakest time of year. Builders tend not to order lumber on a speculative basis but rather in response to existing construction plans, so the current spike in lumber prices should get our attention.



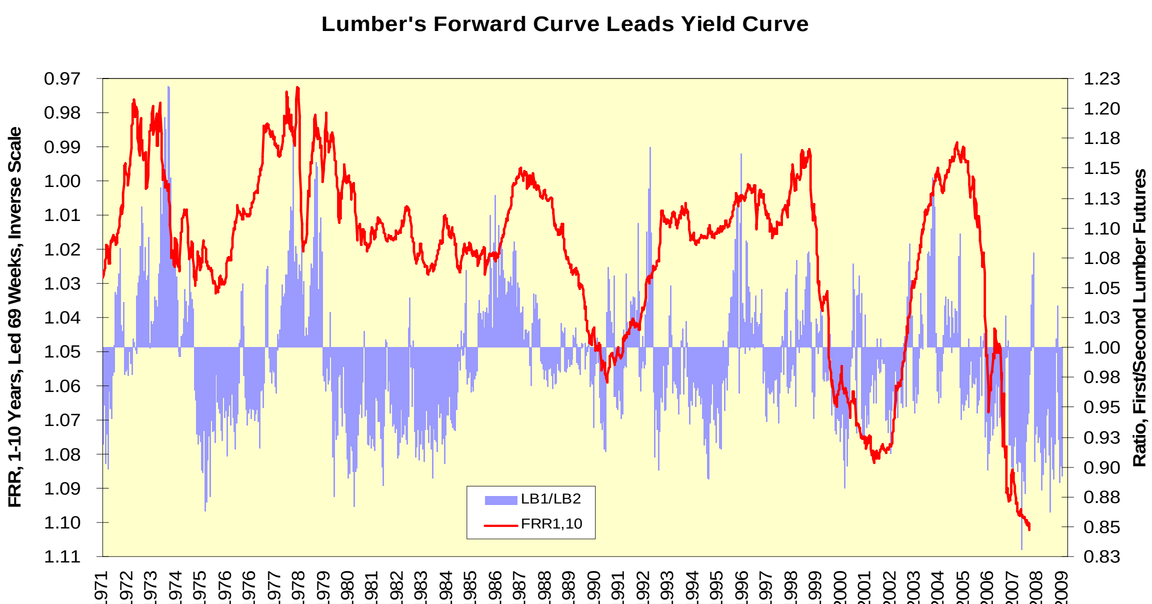
Next, no one should say the current price spike is overextended by any means. The current price was reached first in February 1979. As producer prices have increased 134% since then, the real price of lumber is about 43% of what it was more than 30 years ago. Moreover, the front-month futures are trading at a substantial discount to the second-month futures, quite the opposite of the inverted forward curve characteristic of major price spikes in lumber.

Lumber can move substantially higher in price and the forward curve can flatten before production capacity is restored.



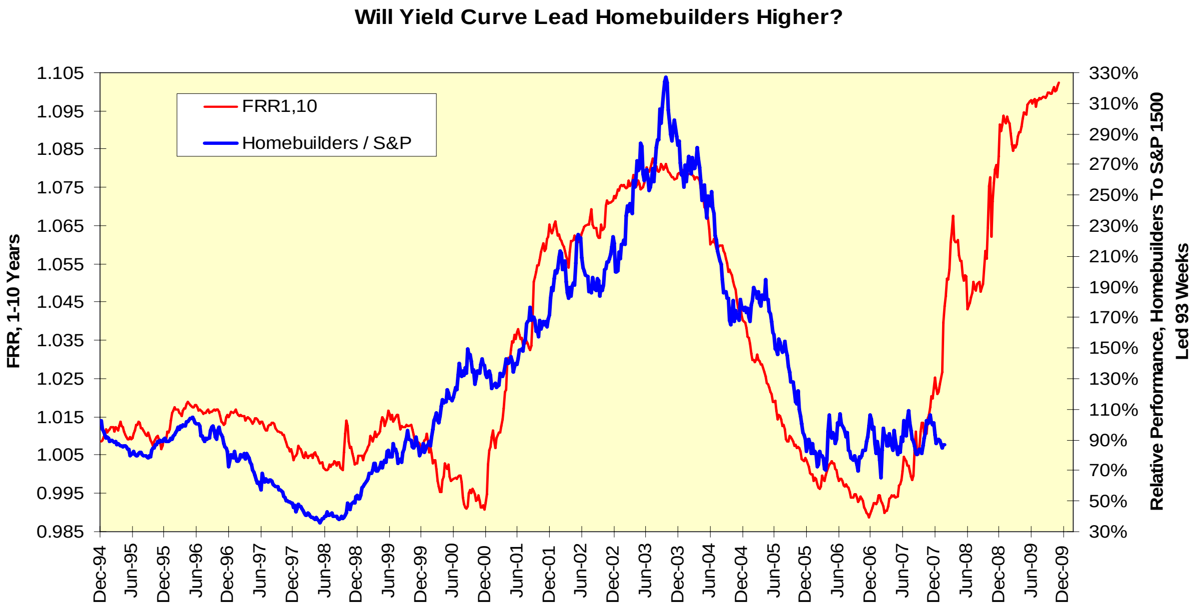
Enter The Yield Curve

The forward curve of lumber tends to lead the forward rate ratio between one and ten years; this is the rate at which we can lock in borrowing for nine years starting one year from now divided by the ten-year rate itself. The lead time actually is a distributed lag centered around 69 weeks, or about sixteen months. This is equivalent to saying a weak housing market causes the carry in the forward curve of lumber futures to deepen, which in turn elicits a monetary policy response. The real question is whether the Federal Reserve will allow this chain to work in reverse; will they tighten in response to any renewed strength in the housing market or will they find any and all excuses to keep short-term rates near 0%?

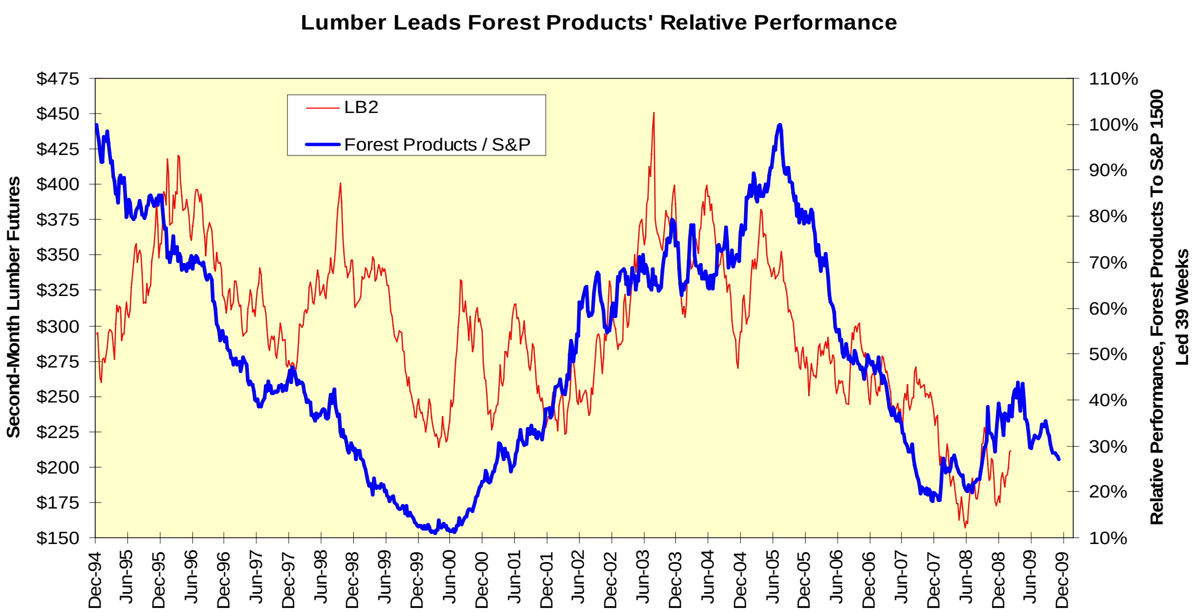


Stock Market Impact

Now we come to an interesting leading relationship, that between the shape of the yield curve and the relative performance of the S&P 1500 homebuilders index to the Supercomposite itself. Here the yield curve has led the relative performance by a substantial 93 weeks, or almost seven calendar quarters. As the Federal Reserve has loosened, it has taken this long to right the housing market. If this relationship holds, a very big "if" given the oversupply in housing in many markets, then the homebuilders should start to outperform the broad market very soon.



Finally, let's take a look at the relative performance of the S&P Forest Products index, which consists of Louisiana-Pacific, Weyerhauser and Deltic Timber to the Supercomposite as a function of second-month lumber futures. The relative performance leads the lumber futures by 39 weeks on average. At present, this indicator is pointing lower, which is perhaps the most negative indication we can come up with for lumber prices at present.



The net result of all this is we are more or less where we were when the great monetary experiment started. Housing starts and hence incremental lumber demand are low and they should remain low until the excess inventory is worked off in key markets. None of the efforts to support housing prices over market-clearing levels, including massive Federal Reserve purchases of mortgage-backed securities and low interest rates have worked. While the stage is being set for housing to rebound, for the price of lumber to rise and for the deep carry in the forward curve of lumber to flatten, for the yield curve to flatten and for the homebuilders' relative performance to improve, this all may be nothing more than a dress rehearsal.