Lumber Traders Are Never Board

Are Yew Pining For Profits? Spruce Up Your Trading and Let The Fir Fly

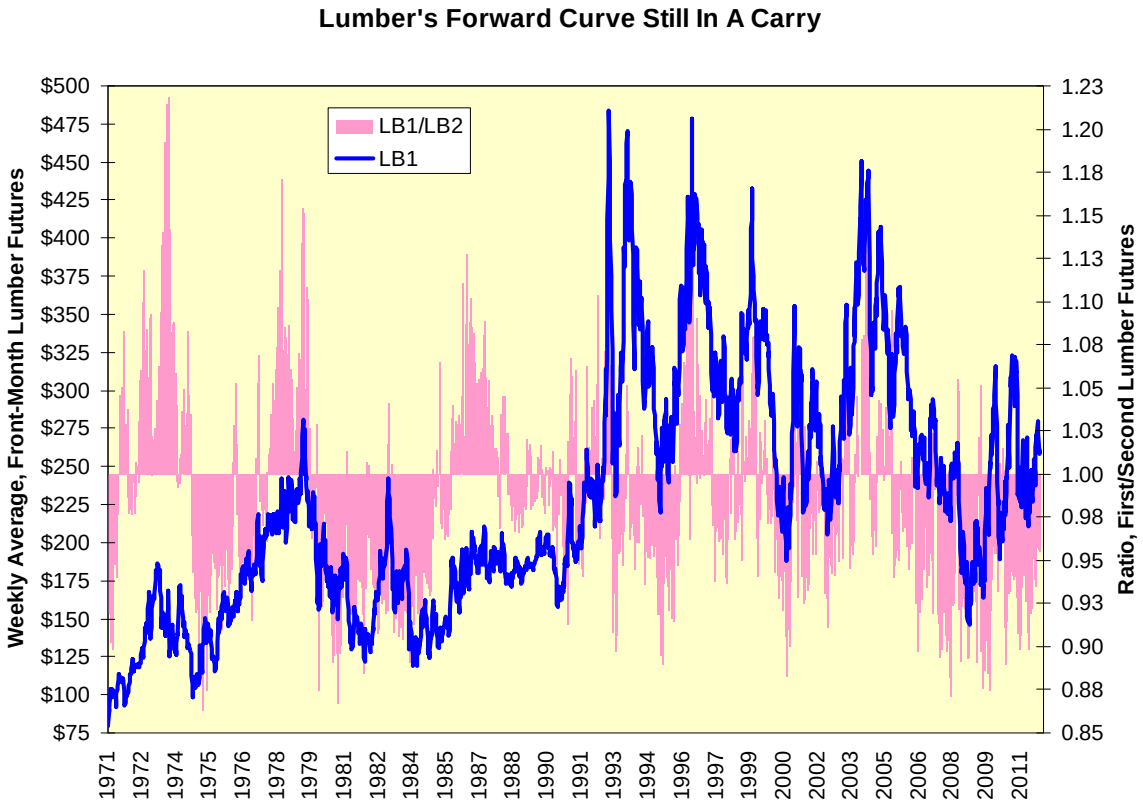
The futures industry has always had something of a hate-hate relationship with forest products. Contracts on plywood and oriented strand board have bitten the sawdust over the years. However, the Chicago Mercantile Exchange's (CME) contract on 2x4 lumber studs, random lengths, has managed to stay in business over the years. The biggest event in lumber's history was the spotted owl controversy in 1993; prices shot limit-up for days on end after a court ruled much of the old-growth forest in Oregon off-limits to logging in favor of our feathered friend.

One of the reasons these forest products contracts have struggled over the years has been the nature of smaller and medium-size homebuilders and supply yards. Unlike the large national homebuilders such as Pulte (PHM), Lennar (LEN), Toll Brothers (TOL) and D.H. Horton (DHI), smaller firms are willing to walk away from fixed-price commitments if the price falls. A supplier to such miscreants may have hedged their fixed-price sales with a long futures position only to lose the sale and be on the losing end of a futures trade to boot.

The lumber market, unlike many smaller markets with low speculator participation, is not as a reliable indicator of housing market conditions as you might wish to believe; it gets battered about by trade disputes under the Softwood Lumber Agreement between the U.S. and Canada and by whole-log exports to Asia. But the forward curve of lumber futures has demonstrated some interesting properties over time.

Inversions

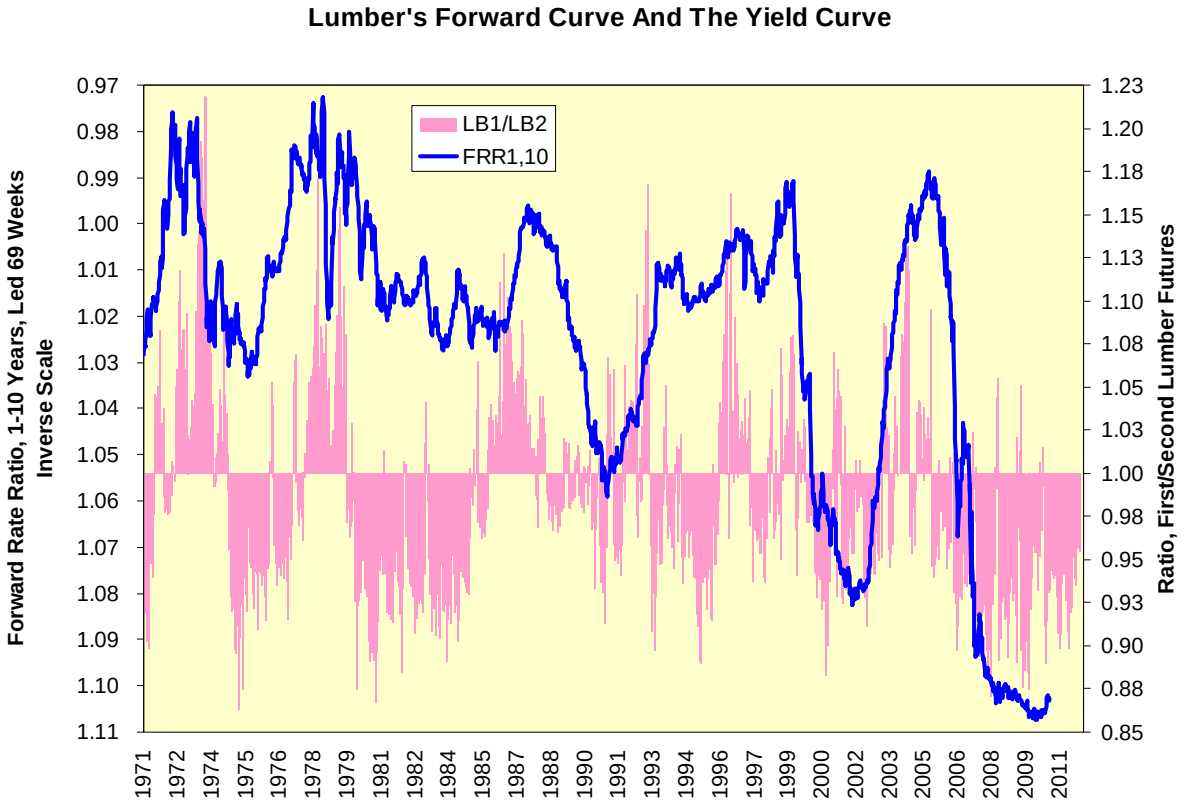
Any commodity bought on a just-in-time basis and where the cheapest place of storage is with the producer should have a naturally inverted (backwardated) forward curve. These curves tend to become more inverted during bull markets and move into deeper carries in bear markets. Such has been the case with lumber since the early 1970s.



While the carry for lumber futures is narrowing, it has yet to move back into an inverted structure. This signals a lower degree of enthusiasm for the recent stabilization or even modest upturn in housing starts. We know from the experiences with homebuilders over the past decade they can be a very optimistic lot; the forward curve of lumber lacks an investor relations department if you know what I mean and I think you do.

Yield Curve

Another odd curiosity about lumber's forward curve is how it leads the yield curve as measured by the forward rate ratio between one and ten years ($FRR_{1,10}$). 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 forward curve leads the yield curve by 69 weeks on average; the narrowing carry in lumber thus is signaling a flattening of the yield curve over the next year and one-half. Of course, this is something of a free forecast as the yield curve hardly could have steepened.



The net of all this is the lumber market is not forecasting a boom in construction and any such boom, should it materialize, would lead to a bearish flattening of the yield curve. The study of trees does constitute an interesting branch of economics, no?