

PERSPECTIVE



Lumber: A Lull after an Exceptional Year

Lumber is often a topic of conversation, and for good reason: sawmills are peppered throughout Quebec and are the economic backbone of roughly 200 communities. Even though local producers are at the ill-humoured trade whims of the Americans, the industry had a good run in 2017 and in the first half of 2018. The year just ended was exceptional owing mainly to the dizzying rise in lumber prices and their dramatic fall in just a few months. This was caused by an unusual combination of factors. While things have not changed completely, it would be surprising for 2019 to be much like the past year. Nonetheless, the elements impacting the market can change quickly, which will keep those with an interest in lumber on their toes.

An Industry with Far-Reaching Roots

Sawmills are not self-sufficient; you can say they have far-reaching roots. On the one hand, they are tied to the intensiveness of construction across the continent. On the other hand, they cannot be completely disassociated from plywood, pulp and paper (mainly wood chips) or furniture production, and even less so from forest activities. Whether sawmills do poorly or well depends on how well all wood products do.

Contrary to what some might think, the lumber industry is not in distress, far from it. However, it is bullied because it must deal with the trade whims of the Americans. Also, Quebec mills do not really have any influence over prices with respect to the rest of the industry in North America; they are what is commonly called “price takers.”

Quebec sawmills accounted for 9,816 jobs in 2017, compared with 9,749 in 2010 (table 1). While the hemorrhage of the early 2000s has been stopped, a drop has been noted in the number of workers in sectors related to the lumber industry.

TABLE 1
Number of jobs in the various sectors of the Quebec lumber industry

	2010	2017
Wood product manufacturing	28,327	28,662
Sawmills	9,749	9,816
Plywood	5,086	5,063
Other wood products	13,492	13,783
Furniture	23,592	22,824
Paper production	24,634	21,060
Printing	16,103	11,771
Forestry, logging and support	11,457	9,273

Source: Statistics Canada

From 2010 to 2017, Statistics Canada reported declines in the furniture (-3.2%), paper (-14.5%), printing (-26.9%) and forestry (-19.1%) industries. Market changes, automation of production processes, the decrease in allowable cuts and major consumer trends (lower demand for paper¹) have changed demand for wood and wood products. Clearly these changes would have an impact on the labour market.

From 2010 to 2017, Quebec’s sawtimber production increased, with a volume of 4.6 billion FBM (foot board measure²) at the beginning of the decade. It reached 6.6 billion FBM in 2017, and 2018 is looking even better so far. Growth from 2012 to 2017 was continuous despite U.S. offensives aimed at restricting Canadian exports. Demand does not come just from south of the border, but Uncle Sam has a strong influence over order numbers across the continent, depressing prices. Canada meets around 30% of that country’s lumber needs.

As mentioned earlier, the roots of the sawmill industry are far-reaching. This is confirmed by the presence of sawmills throughout Quebec, with the exception of Laval and the Island of Montreal. Table 2 on page 2 shows that three regions stand out from the rest with more than 20 sawmills. In 2017, Quebec had 201 mills with an active licence for more than 2,000 m³. Two thirds specialized in softwood and the remaining third, in hardwood. The Chaudière-Appalaches region led the pack with 31 mills, followed by Estrie (29) and Bas-Saint-Laurent (24).

¹ Lower paper demand: growing Internet use led to a reduction in the use of paper in business correspondence, the disappearance of newsprint, the demise of phone books, and so on.

² Foot board measure (FBM): one piece of wood 12 inches long by 12 inches wide and 1 inch thick.

François Dupuis, Vice-President and Chief Economist • Mathieu D’Anjou, Deputy Chief Economist • Joëlle Noreau, Senior Economist

Desjardins, Economic Studies: 418-835-2450 or 1 866-835-8444, ext. 5562450 • desjardins.economics@desjardins.com • desjardins.com/economics

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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TABLEAU 2
Number of mills per administrative region by category
(active licences for more than 2,000 m³) in 2017

	NUMBER
Bas-Saint-Laurent	24
Saguenay–Lac-Saint-Jean	18
Capitale-Nationale	8
Mauricie	8
Estrie	29
Outaouais	15
Abitibi-Témiscamingue	9
Côte-Nord	4
Nord-du-Québec	6
Gaspésie–Îles-de-la-Madeleine	12
Chaudière-Appalaches	31
Lanaudière	9
Laurentides	14
Montérégie	5
Centre-du-Québec	9
Sawmill industry	201

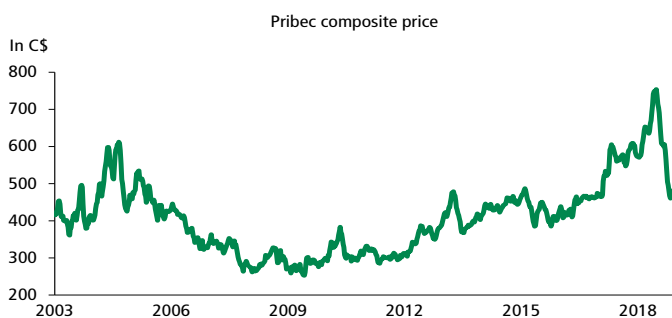
Source: Ministère des Forêts, de la Faune et des Parcs

Sawmilling is still the primary activity in many rural municipalities across Quebec.

2018, an Exceptional Year

This year will have been exceptional, particularly due to the dramatic change in lumber prices (graph 1). They broke a record in June 2018 (C\$726 per 1,000 FBM of 8-foot 2x4s), only to plummet to a low of around \$460 in early November. This is the quickest price drop in three months ever recorded. While the price ascent was welcome and served Quebec, Canadian and U.S. producers well (the latter not having to pay surcharges), it is easy to imagine that the drop was quite a disappointment to them. The plunge occurred on both sides of the border.

GRAPH 1
In 2018, prices peaked before plummeting



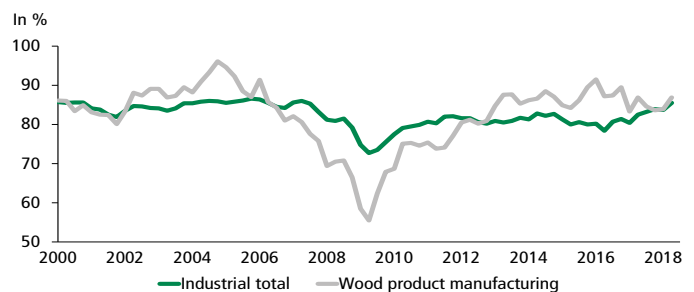
Source: Conseil de l'industrie forestière du Québec

The price level hit in the spring and summer of 2018 was hardly sustainable in the long run. What we have to keep in mind is that prices peaked in a context where they would not have normally reached such heights. North American housing starts for this year are far from being record-breaking. Although they averaged 2 million in the mid-2000s, estimates for 2018 are slightly below 1.5 million units. There has therefore been no overheating on

work sites comparable to the one that caused the real estate bubble in the early days of the millennium.

However, many reasons contributed to the spike in prices in the first half of the year. First, the balance between sawtimber supply and demand on the continent is tighter than in the past. This helps bolster prices. Many phenomena are behind this increased tension. On the one hand, sawmill production capacity is no longer as great in North America as it used to be. It was a little over 80 billion FBM in the mid-2000s and has since settled at under 70 billion. The countless mill closures over at least the past decade have played a part in tightening supply. It is therefore not surprising to see the industrial capacity utilization rate of Canadian mills flirt with 90%. However, we have not reached the heights of the mid-2000s at this level (graph 2).

GRAPH 2
The industrial capacity utilization rate is very high, but not record-breaking



Sources: Statistics Canada and Desjardins, Economic Studies

Then, the wood surpluses on the market as a result of the pine beetle (a destructive insect) infestation in British Columbia are a thing of the past. That is how 3 billion FBM was cut from the province's wood supply in the past two years. Furthermore, the major hurricanes that would blow in once a decade are now more frequent and have placed additional pressure on wood demand (protection and reconstruction). This trend in extreme weather events could continue due to climate change.

More numerous forest fires also reduce the wood fibre available for operations. The major fires of recent years have been a game changer. The state in which the pine beetle left British Columbia's forests makes the province more vulnerable to fires. All these elements combined raise fears of supply in the future. Since the market is continental, the tension affects both Canadian and U.S. prices.

Other factors likely to tighten the balance between supply and demand have been added to the mix. One example are the exports destined for China, which reduce the amount of wood for sale on the North American market.

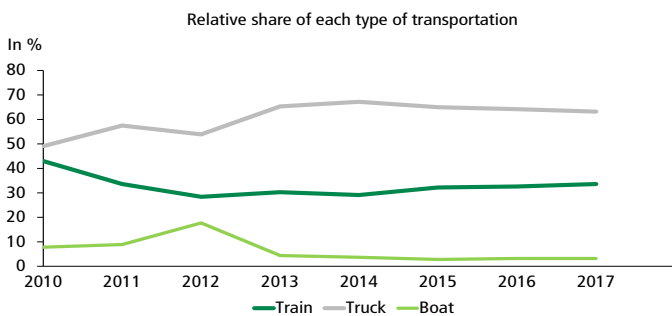
Transportation problems have exacerbated existing challenges. Railway shipments, in particular, were slowed down quite a bit by the harsh winter conditions in the winter of 2017–2018 across Canada. It is worth noting that rail transport accounts for a significant share (33% in 2017) of exported Quebec lumber (graph 3). Competition for rail shipments with other commodities, such as oil and grain, is high. This has brought more tension to the lumber market at a time when truck transport is already affected by serious driver recruitment problems that have been around for many years.

in the summer took some pressure off lumber prices. It was apparent that there were sufficient resources to meet demand. But in this market, like in many others, such as oil, the fear of possible supply tightening drives prices higher. Admittedly, expectations play not so small a role.

The Issue of the U.S. Market

Can Quebec sawmills do without the U.S. market? Not likely, because just under a third of the supply going to the United States comes from Canada. Although the market is a fussy one due to the combative trade whims of U.S. producers, it is an attractive market nonetheless. Changes in the trade balance³ from 2007 to 2017, as shown in graph 4, have been beneficial to Quebec producers these past few years.

GRAPH 3
The relative significance of the railway for transporting exported lumber is not small

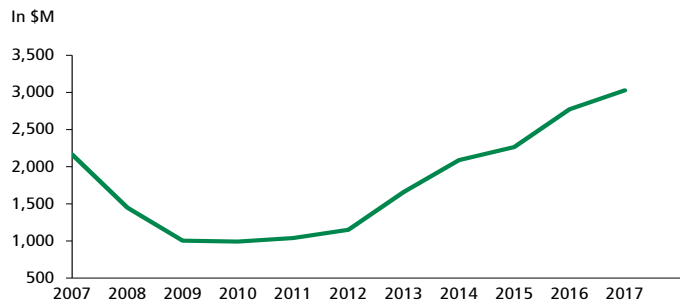


Sources: Ministère des Forêts, de la Faune et des Parcs and Desjardins, Economic Studies

Lastly, one more factor has contributed to the price increase: the anti-dumping and countervailing duties imposed by the United States. Table 3 shows the burden placed on Canadian producers since January 2018 when they want to access the U.S. market. They have a major impact and have contributed to pushing prices up. For the vast majority of businesses north of the border, the combined rate reached 20.23%, i.e., 6.04% for anti-dumping duties and 14.19% for countervailing duties. Five companies saw different rates imposed on them, sometimes higher (e.g., West Fraser Mills Ltd.) and other times lower (e.g., Resolute Forest Products Canada Inc.).

The plunge in prices was just as quick as the rise. Better transport conditions and a cooler housing market in the United States

GRAPH 4
The Quebec trade balance in the wood products sector from 2007 to 2017 is positive and on the rise



Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

Quebec shipments outside Canada are mainly destined for the Northeast region of the United States. The market’s proximity favours this destination. However, it is not the most lively of Uncle Sam’s sectors. The West region is definitely more dynamic, but the states in this region are already well served by their own producers and by those from British Columbia, in particular.

The Canadian market had a very attractive option to offer local sawmills, especially since they were exempt from anti-dumping and countervailing duties. Many Canadian and Quebec companies therefore chose this market to some extent over the United States. While this strategy has paid off in the short term, it may not do so well in the medium and long term. In the past, agreements with the Americans came with production quotas for exporting businesses. These quotas were determined based on a history of shipments to the United States. This means that sawmills that gave Uncle Sam the cold shoulder might end up having rather limited access when a formal agreement is reached with our neighbours to the south.

TABLEAU 3
Current rates for U.S. anti-dumping and countervailing duties

IN %	DUTY RATE		
	Current definitive anti-dumping duties	Current definitive countervailing duties	Current combined definitive duties
Canfor Corporation	7.28	13.24	20.52
Resolute Forest Products Canada Inc.	3.20	14.70	17.90
Tolko Marketing Sales Ltd.	7.22	14.85	22.07
West Fraser Mills Ltd.	5.57	17.99	23.56
J.D. Irving Ltd.	6.04	3.34	9.38
Applicable to others	6.04	14.19	20.23

Source: Global Affairs Canada, as of October 11, 2018

³ This is a combined trade balance for sawmills and wood preservation, wood veneer, plywood, engineered wood and other wood products (wooden doors and windows, for example).

If numerous companies do the same, Canada will eventually have surplus lumber to sell on its own market. This could result in lower prices and make it difficult for local businesses to turn a profit.

What about 2019?

The plummeting prices observed in the second half of 2018 could slow spending on machinery and equipment. These investments are some of the ways in which local mills stay competitive. The sawmill industry has enough challenges to deal with without adding more to the mix: labour shortages, drop in paper mill operations in recent years, limited allowable cuts, transportation problems and a trade conflict with the United States, to name a few.

The coming year is shaping up to be less tumultuous than the previous one. As far as prices are concerned, the declines appear to have stopped, at least until the end of 2018. Demand for lumber and plywood continues to be strong without being overly pressing. Prices might rise in the spring, only to swing tremendously as economic news and events unfold (fires, infestations, strikes, transportation problems, etc.). Volatility should be expected. Housing starts will slow in Canada and Quebec, but should be up slightly in the United States according to the latest Desjardins Economic Studies [forecasts](#). It is worth noting that, according to the U.S. National Association of Home Builders, the average price of a new home has increased by US\$9,000 due to Canada's tariffs on lumber.

Labour shortages in construction on both sides of the border and the expected increase in interest rates will prevent overheating in new construction likely to send lumber prices soaring. Many factors would have to come into play to create a situation similar to that of 2018. For the time being, such conditions do not exist.

Spending on home renovations should increase in Canada in 2019, but at a slower pace than in previous years. In Quebec, a slight decrease in spending from 2018 is expected (-2.0%).

As for the trade war on lumber, we can hardly expect the conflict to be resolved in the near term. For now, none of the bodies with which Canada has filed a complaint have made a decision. We will probably have to wait until the end of 2019 or even 2020 for the first court decisions to start coming out. The case has also been taken up with the World Trade Organization (WTO). Although a decision in favour of Canada is expected, like every other time that the country has turned to the WTO on matters involving lumber, the Organization does not have enforcement powers. It only has persuasive powers.

Meanwhile, since the battle began when the North American Free Trade Agreement (NAFTA) was still in force, Canadian producers were able to file a complaint with the NAFTA trade tribunal under Chapter 19. This body has coercive and retroactive power. Canada has always won in the past and expects

to again this time. It is estimated that by the end of 2018, Canadian companies will have paid C\$2.5 B in anti-dumping and countervailing duties. This money is placed in a trust account for each company. Depending on the court decisions, this money will either be returned to Canadian sawmills—if Canadian companies win their fight—or be paid to the U.S. Treasury—if the United States is the victor. During a previous conflict, US\$5.5 B was set aside for tariffs imposed by the Americans. In the settlement for the 2006–2015 agreement, U.S. producers were awarded US\$1 B after negotiations. At this time, we do not know how much of the money set aside to date will be recovered and, even less so, when that might happen. What we do know, however, is that Canadian companies are being deprived of money that could have been invested to increase their competitiveness.

Many pitfalls still await between now and the resolution of the conflict. “Administrative revisions” will begin in January 2019, as the U.S. Department of Commerce conducts its annual review of anti-dumping and countervailing duty orders. This means that the rates currently imposed might change following the new review, with some companies having to undergo close scrutiny.

What's more, there are a number of coinciding trends that are making our read on the current situation more difficult. On the downside, we have the confrontational attitude of the Americans, which will do nothing to help Canadian sawmills (take, for example, the thorny issue of aluminum and steel). On the upside, we can rely on the fact that the Canadian lumber industry has always won its battles in court during previous conflicts. Add to that Canada's August 2018 victory in another trade dispute involving the uncoated mechanical papers (newsprint) industry. The U.S. International Trade Commission, in the United States, concluded that it posed no threat to the U.S. industry.

To sum up, 2019 will bring price volatility, a review of anti-dumping and countervailing duty rates, a cooler Canadian housing market and a continued gradual increase in interest rates. We should not expect next year to be much like 2018, but rather to keep those with an interest in lumber on their toes.

Joëlle Noreau, Senior Economist