Introduction

As Pennsylvania’s premier forest products lender, it is AgChoice Farm Credit’s business philosophy to continually research and evaluate the industry, assess risk and make sound lending and business decisions. Accordingly, the *Forest Products Industry Outlook* provides insight and guidance on Pennsylvania’s forest products industry.

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Executive Summary

Kiln-dried Appalachian-U.S. hardwood grade lumber prices are down 11% year-over-year (YOY) and down 27% ($375/MBF) from their mid-2018 cyclical highs. Pennsylvania timber stumpage prices retreated 36% ($326/MBF) since the mid-2018 peak, creating relief for some industry participants, while eroding profitability for regional timberland owners. Trade war-related tariffs and weaker Chinese economic growth negatively impacted 2019 financial results for most operations in AgChoice’s service territory. Foreign demand for U.S. hardwood lumber was down 25% in 2019 compared to 2018 (and down 18% YTD May 2020). Additional challenges include vastly reduced pulpwood and chip demand at Pennsylvania, New York and Maine paper mills, as well as tight pallet, blocking and railroad tie markets. Bright spots include low diesel fuel prices and terrific logging weather in June and July 2020 (sunny with little rain). Revenues and profitability will be off considerably in 2020 due to supply chain disruptions and tentative purchasing behavior during the pandemic.

In June, the International Monetary Fund (IMF) revised its economic forecasts downward and now estimates the global economy will contract 4.9% in 2020 (-8.0% for the U.S.), with advanced economies suffering a more pronounced shock than developing nations. Recovery in gross domestic product (GDP) should be more gradual than previous forecasts. As with any major global event, economic forecasts will prove less reliable until underlying pandemic-related shocks subside. Therefore, readers will note that this is a condensed Outlook relative to past versions.

China is our nation’s largest single hardwood lumber export destination. The country’s 2020 economic activity is at 75% capacity following the pandemic, but is currently performing better than during the early quarters of the Great Recession. Chinese demand for U.S. hardwood logs and lumber improved after February’s tariffs removal, just before COVID-19 arrived in the U.S.

Domestic demand has fallen off as cabinet, flooring, moulding and millwork consumption bowed to COVID-19-related restrictions. U.S. housing construction trends are off considerably YOY. In the short term, the U.S. forest products industry will struggle due to the headwinds noted above. COVID-19 will negatively impact 2020 financial results and the resulting global recession. As with any economic cycle, impacts will be uneven from company to company. Operations with stronger liquidity, lower levels of debt, superior management and loyal customer relationships will feel less strain than others. During the past 30 years, we have seen successful operations employ the following strategies to weather economic storms and emerge as viable contenders: reduced capital expenditures, sales of non-strategic assets, tightened cost control, consolidation and reduced operating hours.

Longer term, the United States’ accessible forest growing stock (18% of global standing timber), industrial capacity, innovation and technology are significant competitive advantages that position our industry extremely well.
Watch List Items

1. **COVID-19** is having a devastating effect on the world economy. Most economists believe we are in a recession (ending the U.S.’s longest bull market on record). As of the writing of this outlook, it is evident that we are still in the early phases of this pandemic. While the U.S. and many countries rolled out significant monetary (lowering interest rates) and fiscal (government’s attempt to increase economic activity) stimulus, the pandemic’s long-term economic effects remain unknown. AgChoice clients and staff should consider how this disruption to normal business practices affects all areas of their operations, including liquidity, staffing and employee morale.

2. **Interest rates** remain, historically, very low. On March 16, the Federal Reserve lowered the federal funds rate to 0% and vowed to keep this level until the COVID-19 pandemic is behind the U.S., which should be a significant boon to business owners. Mortgage rates are also low, with the average 30-year mortgage reaching 3.75%. These low interest rates should allow businesses to fund growth and/or increase profitability more easily. Where capital expenditures are necessary, customers should consider fixed-rate debt funding in order to preserve cash and take advantage of the more-affordable debt capital offered by today’s interest-rate environment.

3. In late 2019, experts predicted **U.S. housing starts** to rise approximately 6% in 2020. While the January and February reports by the Census Bureau show housing starts in line with projections, they do not take into account the impact COVID-19 will have the rest of year. Many economists are cautiously optimistic about what the rest of 2020 will hold.

4. **Forest products industry labor concerns persist.** There is a skilled labor shortage across the United States, greatly impacting the industry. Some operations have raised employee wages and improved benefits but are still struggling to compete for available labor. This shortage is most apparent in the logging industry. The workforce in this historically hazardous industry is aging, while young employee/owner entries are too few to replace natural attrition and retirements at historical levels of logging production-per-employee. According to the Bureau of Labor Statistics, and the Department of Agriculture, the number of owners and employees in logging, farming and related fields has fallen steadily since the 1990s, while average producer ages have increased. If this trend continues, and as global demand for forest products climbs, AgChoice staff and clients must weigh creative solutions to revolutionize levels of logging production per employee or attract new entrants to the industry.

5. **The upcoming U.S. election** may have a significant impact on U.S. forest products trade relations because the President’s administration negotiates trade agreements. Given our hardwood forest products industry’s heavy reliance on foreign demand, the election’s impact on trade policy is an important watch-list item for AgChoice’s clients and staff. Each month we get closer to the election, we lessen the likelihood of new pre-election trade agreements. Foremost, potential future trade negotiations include the Phase 2 trade deal with China, which would address substantial items Phase 1 didn’t cover, namely how China handles its support of state-owned firms.

6. The **Spotted Lanternfly** and associated quarantine-zone boundary changes continue to threaten the Pennsylvania timber industry. The Pennsylvania Department of Agriculture
expanded its quarantine zone by 12 more counties (Allegheny, Beaver, Blair, Columbia, Cumberland, Huntingdon, Juniata, Luzerne, Mifflin, Northumberland, Perry and York). Quick, aggressive treatment to newly identified populations in Pennsylvania have been funded through the Rapid Response Disaster Readiness line of the 2019 Pennsylvania Farm Bill. The Spruce Bark Beetle infestation of Central Europe grew over the last two years. Poland, Germany and Austria were the hardest hit. France and Switzerland are reporting its spread as well. This event led to many landowners completing massive harvesting efforts. As a result, Europe has become a key softwood supplier, especially to China, while the U.S. has lost market share there. However, many experts expect this to be a transient event with the harvesting quickly exhausting itself and the U.S. (and other countries) regaining market share.
Readers will note that U.S. hardwood grade lumber prices are off considerably from their mid-2018 highs, driven by a combination of a) retaliatory tariffs China imposed on its purchases of U.S. lumber products and b) weaker economic performance in China (our largest foreign export destination for U.S. hardwood grade lumber). Prices are likely to stabilize as COVID-related fears wane.
Timber stumpage prices fell from the mid-2018 peak (figure above). The green line (below) measures the gap between lumber prices (red line) and timber stumpage prices (blue line). The green line represents the collective operating revenue available among the logger, trucker, sawmiller and kiln operator. **Readers will note the green line is currently well below $550/MBF, which is the historic threshold we’ve observed associated with favorable financial performance throughout the forest products supply chain**, before considering fuel price impacts. Readers can find decades of Pennsylvania timber stumpage price trends at [https://extension.psu.edu/forests-and-wildlife/forestry-business-and-economics/timber-market-report](https://extension.psu.edu/forests-and-wildlife/forestry-business-and-economics/timber-market-report)
Appalachian U.S. low-grade hardwood lumber prices (4x4 and 4x6 cants, shown above) are a critical portion of the overall revenues from sawmills in AgChoice’s service territory. Readers will note that current cant prices are unfavorable relative to historical levels. The center of each log contains knots and pith, disqualifying it for #2 Common grade or better under NHLA grading rules. As such, the center of each hardwood log is destined for the industrial hardwood lumber market, which includes, cants, blocking, pallet, crating, railroad ties and crane mats, not for the hardwood “grade lumber market.” Prices for Appalachian U.S. hardwood railroad ties are below and show much less relative volatility compared to cant markets. **Price isn’t everything, however.** Many sawmills recently stated that markets for blocking, cants and ties are oversupplied, and that those markets have responded by restricting purchasing, not just by reducing pricing. Some sawmills are unable to sell all of their low-grade industrial production (a byproduct of grade lumber production). Quotas are a painful side effect of the COVID-19-related supply-chain disruptions impacting both primary products and byproducts, thus driving inventories up and consuming cash.
Readers will note the sharp drop-off in U.S. housing starts in March 2020 associated with the outbreak of COVID-19. The fall was particularly severe in the northeastern part of the country.
Pulp and paper are critical to the U.S. forest products industry as value-added manufacturing, an outlet for sawmill residuals, a market for lower-value trees produced during growth-enhancing silvicultural thinnings and a key employer. Readers will note the sharp drop in pulp prices since mid-2018’s peak. Experts predict prices to remain down until global economic activity returns in 2021.

Diesel prices remain down, on depressed economic activity, which benefits loggers’ and log truckers’ cost structure, but has come at the expense of lower overall domestic demand for those services. Readers can expect muted economic activity until there is a meaningful reduction in daily new COVID-19 case statistics.
Existing IMF economic forecasts project significant losses to GDP for most developed nations, while emerging economies are likely to experience more modest GDP erosion in 2020. The global GDP growth forecast is at 5.4% for 2021.

The U.S. forest products industry grew more export-dependent following the Great Recession. Readers will note the 16% YOY reduction in 2019 exports. YTD 2020 exports are down 13% versus last year.
Hardwood lumber is the largest segment of overall U.S. forest products exports. In 2019, U.S. hardwood lumber exports were 25% below 2018 levels. YTD 2020 hardwood lumber exports are down 18% versus last year.

AgChoice’s Forest Products Team is proud to serve the Outlook’s readers and strives to remain the premier lender to the Pennsylvania forest products industry. The Association’s combined forest products loan portfolio (above) continues a favorable growth trend, currently exceeding $200 million, and includes local branch loans and capital markets business.