

Optimism in first quarter of year may be overdone

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If optimism was a driver of demand then the tropical timber industry would be celebrating the return of the good days. From SE Asia, through West Africa to the mills of Brazil, the timber trade is awash with optimism that the markets are reviving.

But is this optimism justified? Admittedly demand in China and India has improved, driven by domestic demand, stimulated by government stimulus measures. But, the story in the traditional western markets is different and there is little evidence that the fundamental indicators of demand, construction activity, consumer spending and GDP growth are improving. The declines in the major economies have been halted, but that should not be cause for the level of optimism currently promoted by the tropical timber sector.

Global growth

In an update of global growth projections the IMF notes that global economic performance improved during the third and fourth quarters of 2009 prompting a revision of estimated global growth for 2010 to 3.9 per cent, up from 3.1 per cent. The growth in China and India and other emerging Asian economies is expected to be robust, but growth will be very variable in developed economies.

Two speed world: Global GDP growth (%)

Country/Region	2009	2010
US	(-) 2.5	2.7
UK	(-) 4.8	1.3
Euro Area	(-) 3.9	1.0
Japan	(-) 5.3	1.7
China	8.7	10.0
India	5.6	7.7
Emerging and Developing Economies	2.1	6.0
World	(-)0.8	3.9

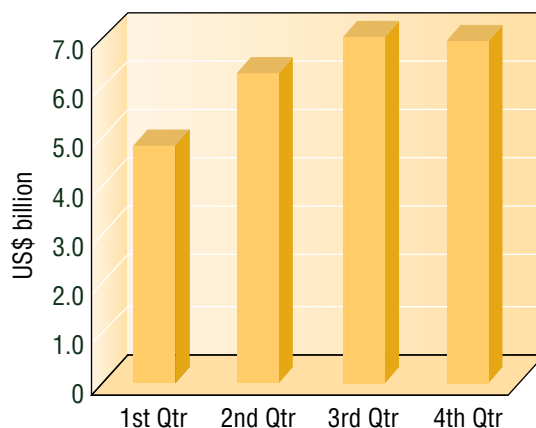
Source: World Economic Outlook Update, IMF, January 2010

Look to China

In 2008 and 2009 Chinese wood product exporters experienced weak demand in overseas markets and this led to a sharp drop in China's timber imports. Analysts see this situation slowly being reversed as demand in the US and in the EU starts to recover. However, the economies in the main consumer markets are still fragile and it will take some time for demand to grow back to pre-crisis levels.

Soon after the economic recession in 2008 and early 2009, demand for wood products in China's domestic market began to recover in tandem with the strengthening of the national economy. Domestic consumption of wood products (logs, sawnwood, veneers and wood-based panels) is forecast to continue to rise throughout 2010. The main drivers of this increased demand are varied. First, the property market in China picked up quickly beginning in the summer of 2009 and sales in some cities were even higher in late 2009 than in 2007. The expansion of the housing market stimulated the consumption of furniture and joinery and it also stimulated

Recovering: China's wood product imports, 2009



infrastructure development, another major end use for wood products. Chinese analysts anticipate that trading volumes for most wood products will grow during 2010, but not rapidly.

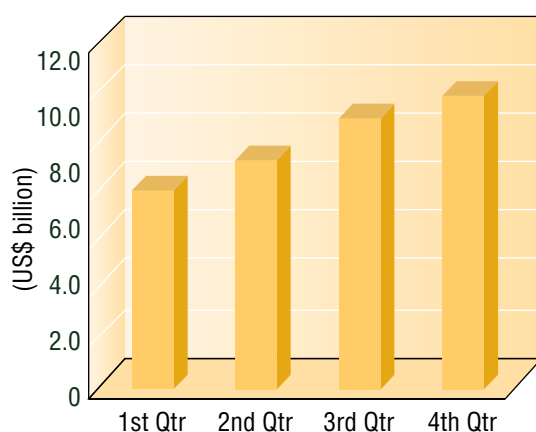
Log imports down, forest products exports up

Log imports in 2009 totalled 28 million m³, valued at almost US\$4.1 billion, down 5 percent in volume and 21 percent in value from 2008. Of the total, imports of softwood logs were 20.3 million m³, up 9 percent, imports of hardwood logs were 7.76 million m³, down 30 percent; imports of tropical logs were only 6.1 million m³, down 15 percent from 2008. Analysts point to two main reasons for the decline in China's log imports in 2009. One is that the overall market was quiet. Although the domestic construction sector remained active due to the government stimulus, related industries like furniture and flooring only began to revive much later.

Statistics from Chinese Customs show that 2009 exports of forest products, including paper and paper products, plywood, fiberboard and other wood products had not recovered to the level of the previous year except in the case of wooden furniture for which the export value rose 9.2 percent. Analysis of the data for each quarter shows that export levels are gradually improving.

A plan for the revitalization of the forest industry in China over the period 2010-2012 has recently been made public. This will serve as the foundation for an action plan to support

Export bounce: Quarterly forest products exports, 2009



the industry through the current global economic crisis. The plan aims to raise the output value of the sector and to maintain growth of around 12% annually. It will aim to achieve this in three years by focusing on support for 100 national leading enterprises and 10 large wood industry clusters across the country.

The output value of the forest industry is set to increase from RMB1.44 trillion in 2008 to RMB2.26 trillion in 2012. The planned output of the wood-based panel sector will be around 100 million m³. The total value of wood products trade is expected to be over US\$90 billion of which US\$50 billion would be accounted for by exports in 2012. Export products such as wood-based panels, wooden flooring, furniture and wooden doors are to be given priority. To meet these targets timber imports are forecast to increase to over 60 million m³ (log equivalent) per year. The number of employees in the wood processing sector is set to increase to 57 million from the current 45 million.

India consumes

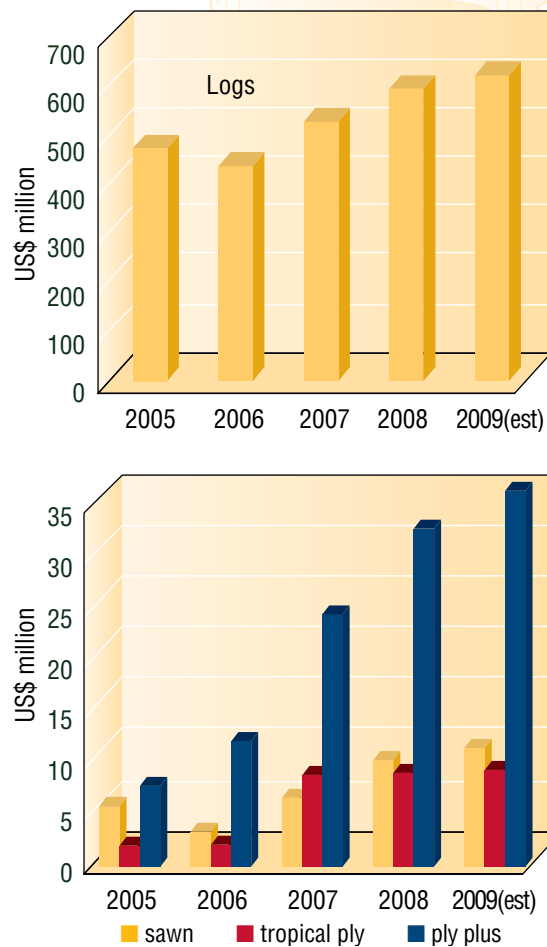
Growth of the Indian economy continues to be strong with the Indian Planning Commission's latest assessment for annual GDP growth at 6.3% with inflation being held at around 5%. Wood consumption in India is growing fast and although the country has over 250 commercial timbers (including some of the most highly prized tropical hardwoods like teak, rosewood, padouk, red sanders and sandalwood), a strict conservation policy limits harvesting. This means India is a net importer of wood and wood-based panel products. Indian industrial demand for wood jumped from 58 million m³ in 2000 to 85 million m³ in 2008 and is expected to exceed 150 million m³ by 2018.

Indian manufacturers prefer to import timber in log form to feed the domestic industries. Imports are mostly from Malaysia, Myanmar, Indonesia, Nigeria, Ivory Coast, Ghana, Togo, Gabon, Brazil, Panama, Costa Rica, Ecuador and New Zealand. Imports of sawnwood have been increasing over the past year as the difference in import duties for logs and sawn timber has narrowed and because exporting countries are offering sawn timber at competitive prices. Log consumption in the Indian panel industry is met largely from plantations, agro-forestry and (limited) natural forests. The concept of industry owned plantations of eucalyptus, poplar, casuarinas and *Acacia mangium* is gaining popularity and this helps a lot in preventing illegal felling in State forests.

As in other markets, housing growth is a major driver of timber demand. In early 2010 the Indian property sector shifted perceptibly towards a seller's market and this is reflected in housing starts and timber imports. Business in the timber sector, especially for sawnwood and wood based panel products for the housing sector was brisk in the first quarter 2010. Reports suggest considerable increases in demand for PF bonded film faced plywood and doors and frames. Analysts say the market for machine made doors and frames is steaming ahead with a growth rate of about 15% per annum and this is driving the re-tooling of old factories.

India can no longer satisfy its demand for industrial roundwood from domestic resources and as a result imports of industrial

Moving up: Indian log and forest product import trends



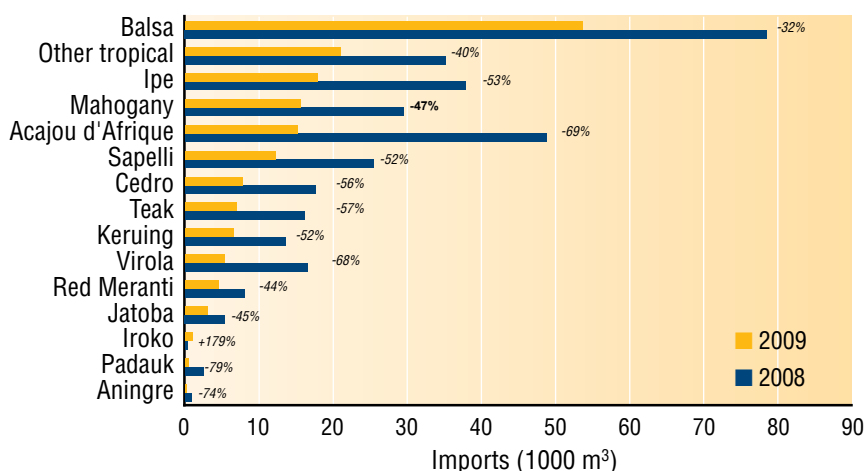
wood have grown threefold during the last ten years, comprising mainly tropical logs from ITTO producer countries. However log imports of around 2 million m³ annually still account for only a small share (under 5%) of the national consumption of industrial roundwood.

US market down

Trade statistics show that US tropical sawnwood imports in 2009 were 34% lower than in 2008. Only teak maintained 2008 import levels in 2009, with imports of most other species at much lower levels. US housing starts in 2009 were at record lows but housing permit approvals increased by 11% in late 2009. However, housing starts continued falling and were down 4% according to the latest US Census Bureau data. Housing starts remain far below the high levels seen in recent years and the large number of foreclosed homes for sale is slowing down the construction of new homes. Analysts point out that consumers in the US are still waiting to see significant improvements in employment and the economy. The expanded homebuyer tax credit should continue to provide some support to sales of new and existing homes but the outlook for hardwood companies supplying the non-residential construction sector is gloomy.

In the first quarter 2010, demand for multi-family units was reportedly higher than for institutional, commercial and industrial projects. Only construction of public buildings such as for government, healthcare and education continues to be

Mostly down: US tropical sawnwood imports, 2009 vs 2008



Source: Department of Commerce, U.S. Census Bureau, Foreign Trade Statistics

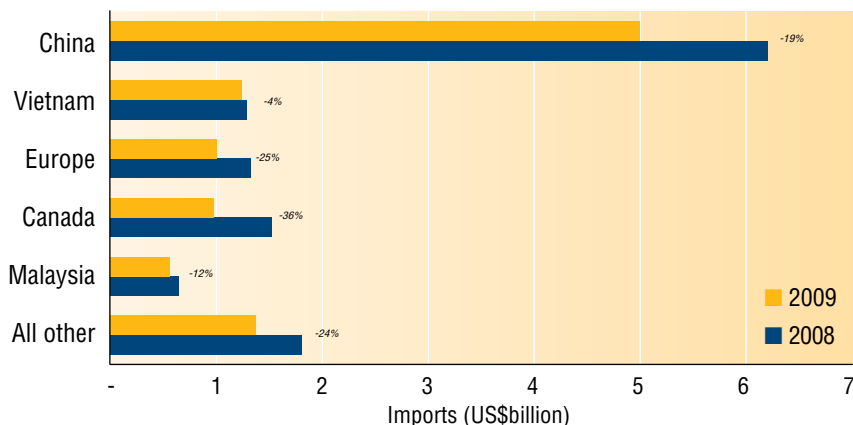
strong. It is in this segment of the market that demand for certified wood products tends to be highest.

Interest in sustainable and energy efficient homes is growing in the US. According to a report on remodeling trends by the Joint Center for Housing Studies at Harvard University, consumers have a growing interest in products that meet three additional green goals: quality and durability, environmental performance, and safety and disaster mitigation. Younger age groups have a particularly strong interest in “green” building and remodeling, which indicates that growth in green product attributes may continue to be strong in the coming years. On the down side, increasing spending on remodeling related to energy efficiency means that on average, Americans spend less on high-end remodeling projects that are more likely to use tropical timber, such as flooring and decking additions and replacements.

Furniture demand down

US imports of furniture have risen sharply in recent years as the industry has become more global. Falling tariff rates as well the fact that China, Vietnam and many Eastern European countries joined the World Trade Organization have contributed to rising imports. However this growth moderated in 2009 (see chart). Furniture orders in the final quarter of 2009 showed the first signals of the end to the declines registered in the early part of the year. But, on a less positive note, sales of furniture in the US dropped by 1.4% in January 2010, in contrast to

Cooling: US wooden furniture imports, 2009 vs 2008



Source: UN COMTRADE

overall retail sales which increased by 0.6%, according to the US Commerce Department. Relatively high unemployment, low consumer confidence and a depressed housing market continue to dampen furniture sales.

Outlook for 2010

Many US hardwood companies expect business in 2010 to be similar to that in 2009 in terms of market demand. Most companies surveyed for the Import/Export Purchasing News in late 2009 agreed that the housing and commercial markets may improve in late 2010 or even later. Higher ocean freight rates will be a challenge for US importers and trading in general. While some expect a slight improvement in business in 2010, the consensus is that if the market recovers faster than expected, hardwood suppliers would not be able to keep up with demand. Inventories are currently very low, which has helped keep prices up. The US hardwood industry went through severe cost cutting measures in 2009, and many mills and businesses folded. Since demand has been hard to predict, many hardwood lumber customers now wait for orders before sourcing lumber. As a result, distribution centers and concentration yards have had to adjust to just-in-time delivery. Properly managing inventories and cash flow will remain a priority in 2010.

Once the US and European economies recover, companies will have to compete with Chinese manufacturers for raw material that is in some instances less available than before the recession. For tropical species in particular, the Lacey Act may reinforce a supply shortage and lead to higher prices in the US market. It remains difficult for producers to sell to the US market at current asking prices, given the slow economic recovery and the weak US dollar. Exporters demand higher prices in line with exchange rate movements, but US buyers are reluctant to purchase. Inventories are so reduced that shortages are already emerging.

EU market bottoming out

The unprecedented fall in EU hardwood imports in 2008 and 2009 reflects the dramatic economic downturn across Europe. The sheer scale of the downturn took many economists by surprise. EU GDP fell by around 4% in 2009 according to the most recent European Commission figures. This compares to a fall of only 1.8% predicted at the start of 2009. The euro-area economy crawled out of recession in the three months to the end of September 2009 and GDP rose across the euro-zone by 0.4%, the first quarterly increase for more than a year.

Europe-wide construction forecasts to 2011 have been published by Euroconstruct. This report indicates that 2009 was the worst year for the construction market in the 19 countries of the Euroconstruct area for more than a decade. Construction output fell by 8.4%, a significantly larger contraction than seen elsewhere in the economy. For 2010, Euroconstruct expects another, albeit smaller, decline in construction activity of 2.2%. Recovery is not expected until 2011 and growth is unlikely to reach a level comparable to that before the recession until at least 2012.

While the European economy is expected to return to growth in 2010, the indications are that the rebound will be very weak

across the continent. Prospects are dampened by a wide range of factors including: high and rising levels of unemployment; over-capacity in the construction sector following the bursting of property bubbles in several countries (notably Spain, Ireland and the UK); and the continuing unwillingness of European banks to provide credit, particularly to smaller businesses and households. To make matters worse, many European governments have to deal with very high fiscal deficits, greatly reducing their ability to stimulate economic activity.

Cloudy with bright spots

Amongst the gloom there are a couple of bright spots for the hardwood industry. Activity in the European joinery sector, particularly windows, is receiving a boost from government stimulus measures focused on improving the energy efficiency of buildings in some countries, notably Germany and France. Furthermore, in those countries like the UK where the property bubble has burst and new residential building is in the doldrums, maintenance and renovation work is more stable as property owners are choosing to “improve rather than move”.

While the economic downturn has been universally felt across Europe, its depth and the likely strength of the rebound varies between countries. GDP in Germany shrank by 5% in 2009 and is expected to rebound only weakly in 2010. Unemployment is expected to jump this year from 3.1 million to 4.5 million, a painful rise that will dampen consumer confidence and spending. A wide range of government measures have been implemented in order to stimulate growth.

Due to high dependency on the financial sector, GDP fell sharply in the UK during 2009, by around 5.9% from peak to trough. The UK remained in recession during the first quarter of 2010. UK GDP is forecast to grow weakly in 2010. Unemployment continues to rise and is expected to peak at around 9% of the workforce in 2010. UK housing market statistics had improved marginally at the beginning of 2010. However, prospects for the timber sector in the UK for 2010 are dampened by wide expectations of rising interest rates together with higher taxes expected after the recent general election. The new government is expected to rein in the country's massive fiscal deficit.

GDP in France is expected to grow by 0.9% in 2010. The French government has been spending freely in an effort to counteract the effects of the recession, supporting employment and bringing forward planned public investment projects. However this is at the cost of a large budget deficit. While the economy has stabilised there is unlikely to be significant growth.

Tight fiscal policies in Italy leave little room for economic stimulus. There also appears to be little appetite for structural reform, suggesting Italy will not be well placed to benefit from the global upturn and its economic position in Europe will continue to weaken. Economic growth of only 0.4% is expected in 2010. During late 2009, industries focused on exports, such as furniture, were reporting that sales had fallen by nearly 50% compared to the previous year, mostly due to the strength of the euro (now reversed). Traditionally Italian wood

importers carried relatively high stocks, but during the current downturn companies have followed the trend to greatly run down stocks.

A property bubble has resulted in Spain and Ireland being severely hit by the ‘credit crunch’. The construction sector collapsed, feeding through into a dramatic decline in key wood processing and manufacturing sectors. Spain's large door manufacturing sector has suffered from widespread bankruptcies and production is believed to be down by more than 50%. Prospects for any improvement in Spain's economy in the short to medium term seem poor.

Due diligence legislation

Timber producing countries exporting to the EU will soon face new challenges. Agreement has been reached in the EU on the text of proposed “due diligence” legislation targeting illegal logging. This legislation would not monitor the legality of each individual import, but would require European companies that “first place” timber on the EU market to operate a management system designed to minimise the risk of their trading in illegal timber. The legislation would apply to all timber products (everything from logs through to finished furniture) from all sources. The legislation would define illegality in relation to the laws of the country where timber was harvested.

A key aim of the legislation is to boost European market demand for wood legally-licensed under the terms of Forest Law Enforcement, Governance and Trade (FLEGT) Voluntary Partnership Agreements (VPA) between the EU and a range of tropical countries. So far the EU has completed VPA negotiations with Ghana, the Congo Republic and Cameroon. Formal VPA negotiations are on-going with Malaysia, Indonesia and Liberia. Preliminary dialogue towards a VPA is underway with CAR, Gabon and Vietnam.

Conclusion

On the face of it the timber trade's optimism in a global turn-around in demand for tropical wood products seems ill-timed. Admittedly there are some markets, for example China and India, where the prospects have improved rapidly and where growth can be expected. However these markets are primarily for raw materials rather than finished products, so downstream manufacturers dependent on the US and EU markets will face a period of stagnant demand. The answer is to rapidly diversify markets and develop strategies on pricing, standards, delivery and trading terms to suit the peculiar attributes of each individual market.