Hancock Natural Resource Group®

A Manulife Investment Management Company

Timber Market Outlook: COVID-19 Scenario Analysis

Economic/Policy Backdrop

Market Dynamics

- Measures taken to combat the COVID-19 pandemic are likely to give rise to a major economic correction worldwide in 2020, and the 2020 economic downturn in the U.S. and globally may be one of the deepest on record. Even with the passage and implementation of the CARES Act and the U.S. Federal Reserve's emergency provision of extra liquidity to the U.S. economy, forecasts as of April 23rd for the Q2 2020 U.S. inflation-adjusted GDP range from -25% to -45%, SAAR.

Forecasts of U.S. GDP for 2Q 2020 (real, q/q, SAAR)
(estimates as of April 23, 2020)

	Forecast
UBS	-25
Citigroup	-28
Rabobank	-31
JPMorgan Chase	-40
Barclays	-45

Source: Bloomberg, April 30, 2020

- Residential construction and home repair & remodeling are the key drivers of forest product demand (lumber and wood panels), with the COVID-19 pandemic already generating challenging headwinds. Major setbacks in employment and the stock market are eroding consumer confidence and impairing the ability to qualify for financing, which will then restrict home buying. In fact, JPMorgan Chase recently announced tighter lending standards for new home loans (higher credit scores/larger down payments) to compensate for the heightened uncertainty stemming from the COVID-19 pandemic[1]. In addition, quarantines and social distancing are hampering potential home buyers from shopping for properties, thus putting purchasing decisions on hold.

[1] *Forest Economic Advisors*, April 14, 2020: https://www.getfea.com/end-use/jpmorgan-chase-announces-higher-standards-for-most-new-home-loans

- Second and third quarter construction activity may also be impeded by worker shortages due to actual illness as well as the fear of contagion, and interruptions in the supply chain for home builders. To add to this, China is a major source of both interior and exterior building materials – from doors and floors to drywall, insulation, roofing and shingles.
- Lumber and wood panel prices have already sharply corrected downward, declining close to the lows of late 2018 and early 2019. Faced with reduced demand this year, major wood product producers have already begun to implement major production curtailments in expectations of reduced demand in 2020. Lower demand at the mill is translating into downward pressure on the price of sawlogs.
- As we emerge from the COVID-19 upheaval, record-low mortgage rates and softening home prices should help reactivate residential construction in the U.S., returning residential construction to its historical role as the sector-leading the economy out of recession.
- The U.S. pulp and paper sector is expected to have a mixed response to the COVID-19 pandemic across its various product segments. On the one hand, demand for paper will be negatively impacted by large pull-backs in printing at offices, for conferences, for print advertising, and at closed schools and universities. (Graphic paper facilities have already announced production cutbacks – Domtar's Kingport, TN and Ashdown, AR plants, for example)[2]. On the other hand, this weakness in paper demand may be offset to a degree by gains in the consumption of paper packaging, tissue and non-woven materials from the increased use of hygiene products, wipes, towels and protective gear for medical providers.
- The pandemic will accelerate the shift to online ordering and home delivery of retail goods, groceries and meals.
- In an environment of weaker demand, timber prices are expected to move lower, but demand and the extent of the price retreat will vary significantly by region. Timber prices in the U.S. South were already showing compressed margins, with limited room to correct lower, while in the West, timber prices trended higher in 2019, and this year are likely to drop back close to cyclical lows reached in late 2018/early 2019.
- Timber producers in Australia, Chile and New Zealand are expected to be impacted depending on the specific features of their domestic economies and their level of exposure to export markets. New Zealand will be particularly vulnerable to a major downward correction in radiata pine sawlog prices, given their large exposure to the Chinese market and the four-week shutdown of timber harvest operations required until the end of April (forestry was not classified as an essential industry)[3]. Chile is also expected to face significant headwinds from reduced domestic and export demand – the overall economy will likely fall victim to a combination of COVID-19 business shutdowns and social distancing, as well as weaker export markets for key commodities such as copper.

Scenario Analysis*

Two scenarios have been developed illustrating potential pathways to resolve the health crisis and achieve an economic recovery. Amid this fast-moving pandemic and the unprecedented policy responses, forecasting has become extremely problematic and projections must be met with some skepticism. These scenarios are not meant to offer a best and a worst case, but rather suggest a range of plausible outcomes, which we believe have a reasonable chance of materializing. These scenarios involve assumptions based on current data, forecasts from a range of third-party analyses, and the progress of countries that were early victims of the coronavirus outbreak (China, Japan, Korea, Singapore and Taiwan) and which are now in the process of restarting their economies, rolling back quarantines, re-opening shuttered businesses, and easing travel restrictions.

(a) U.S. Baseline Scenario – V-shaped recovery

Economic and sector-specific assumptions

The U.S. will begin to emerge from stay-in-place measures in May. Return to normality will proceed in phases in the third quarter as we see steady improvement in the incident rate of COVID-19. Ongoing improvements in the response to incidents of COVID-19, including monitoring, tracking, treatment and containment efforts, will reinforce the economic recovery and add to its momentum. Large segments of the U.S. economy will approach normal functioning in the fourth quarter, supported by the government's massive fiscal and monetary stimulus.

At the end of 2020 and in early 2021, some sectors will still contend with obstacles in the supply chain (construction, manufacturing, tech), weak offshore demand and increased international competition (agricultural and

* The following is for informational purposes only. Future market movements may differ significantly from the expectations expressed herein, and past performance is no guarantee of future results.

[2] https://www.texarkanagazette.com/news/texarkana/story/2020/apr/06/domtar-layoff-142-ashdown-mill-it-shuts-down-a62-machine-three-months/823348/

[3] https://www.globalwoodmarketsinfo.com/new-zealands-lockdown-forces-forest-products-industry-to-shut-down/

other globally traded commodities), and some will face new consumption patterns (travel and entertainment, retail and commercial real estate). However, in the first half of 2021, the U.S. economy will regain forward momentum with material gains in employment as U.S. retail businesses reopen, consumer confidence rebounds, and international trade returns to normal. Housing activity should benefit from historically low interest rates, deferred purchase decisions, and a dip in home price appreciation.

Implications for timberland operating results and cash flow

Timber income will suffer from delayed harvests and weaker pricing in the second and third quarters of 2020, but should start to improve by the fourth quarter, as U.S. construction activity begins to normalize and China's economy recovers. Housing starts for 2020 are likely to be down year-over-year by 7–12%, with a corresponding decline in timber demand and prices. Forest Economic Advisors is projecting U.S. housing starts to slip from 1.30 million units in 2019 to 1.21 this year, and then surge up to 1.52 in 2021[4].

Implications for regional timber prices

Timber price response to the COVID-19 related 2020 economic downturn will vary by region: the following provides an updated regional COVID-19 Baseline Scenario timber price forecast, which assumes a return to HNRG's previously projected long-term trend for subsequent years.

Prospective changes in property and investment values

Timberland values are likely to adjust lower, based on dampened expectations of future demand and timber revenue, and increased perceptions of risk. This downward timberland price adjustment, however, will be moderated by timber volumes accumulating on properties due to delayed harvesting. Timberland values in the U.S. could move lower in 2020-2021 by 5-7%.

(b) Pessimistic Scenario – U-shaped recovery

Economic and sector-specific assumptions

With persistently high infection rates, the intermittent emergence of new hot spots, and only marginal relief from seasonally warmer weather, widespread U.S. stay-in-place protocols remain in effect well into the third quarter. Economic recovery is hampered by a second round of infection in the fall and early winter of 2020, resulting in continuing restrictions on travel, assembly and business activity, as well as further cautious consumer and business behavior and only a sluggish improvement in employment.

The difficulties experienced by the U.S. in regaining economic traction are amplified by a disappointing response to the COVID-19 outbreak in Europe and in developing and emerging economies; the result is a more extended downturn in the U.S. along with a pronounced global economic recession. This U-shaped recovery, in contrast to the V-shaped recovery envisioned in the Baseline Scenario, delays a robust bounce-back in economic growth until mid-2021.

The extended nature of an economic downturn in the U.S. and abroad (assumed in the Pessimistic Scenario) results in permanent losses in GDP potential and in-place manufacturing capacity, and will call for additional government intervention. Expanding federal and state deficit spending will set the stage for raising individual and business tax rates, further dampening hope of future economic progress. A moderate but choppy recovery in the U.S. economy takes hold in the second half of 2021, marked by slow and uneven upticks in the job market, as well as a more languid improvement in consumer and business confidence compared to the Baseline Scenario. Despite low interest rates and retracting home prices, housing starts remain close to 1 million units in 2021.

Implications for timberland operating results and cash flow

An extended lock-down of the economy will result in more distress in the construction sector, with housing starts possibly dropping back 25–35% to 1.0 million units (SAAR) in 2020. A recovery in 2021 could still be relatively robust – this was the case following the 1982 recession and housing bust. Revenues and income for timberland owners would be negatively impacted, with the greatest swings experienced in those regions with the highest price variability (New Zealand, British Columbia and the U.S. West Coast). Operating results could, depending on location, drop between 15% and 35%.

[4] *Forest Economic Advisors,* March 30, 2020

Implications for regional timber prices

Timber price response to the COVID-19 related 2020 economic downturn will vary by region. Western timber prices under a Pessimistic Scenario would fall hard in 2020, in the range of 9% to 15% and follow a slower return to pre-COVID price expectations over 2021 and 2022. Timber prices in the U.S. South would fall 1% to 3% in 2020, followed by reduced or slowly appreciating prices for 2021 and 2022, and not until 2023 would prices gain notable appreciation.

Prospective changes in property and investment values

Timberland values would correct downward, but the rate at which prices decline would be slow, as sales activity drops markedly and markets become more illiquid. Appraised values would trend lower, but likely find some support in the increased timber inventories on properties as a result of delayed harvests and a lack of comparable sales data. In a distressed financial market environment, investor interest in holding timberland as a long-term safe-haven asset should increase and offset some of the downward pressure on timberland values. Timberland prices under this Pessimistic Scenario could decline by 7–15% in 2020-2021, depending on location.

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Important Information

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Hancock Natural Resource Group
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