

The China Effect

This article will attempt to demonstrate change in international hardwood lumber markets the past several years; pinpoint where business is now; and look forward to where the US hardwood lumber industry is headed. Projecting forward is a tall task for a fragmented industry like the hardwood industry in a global marketplace.

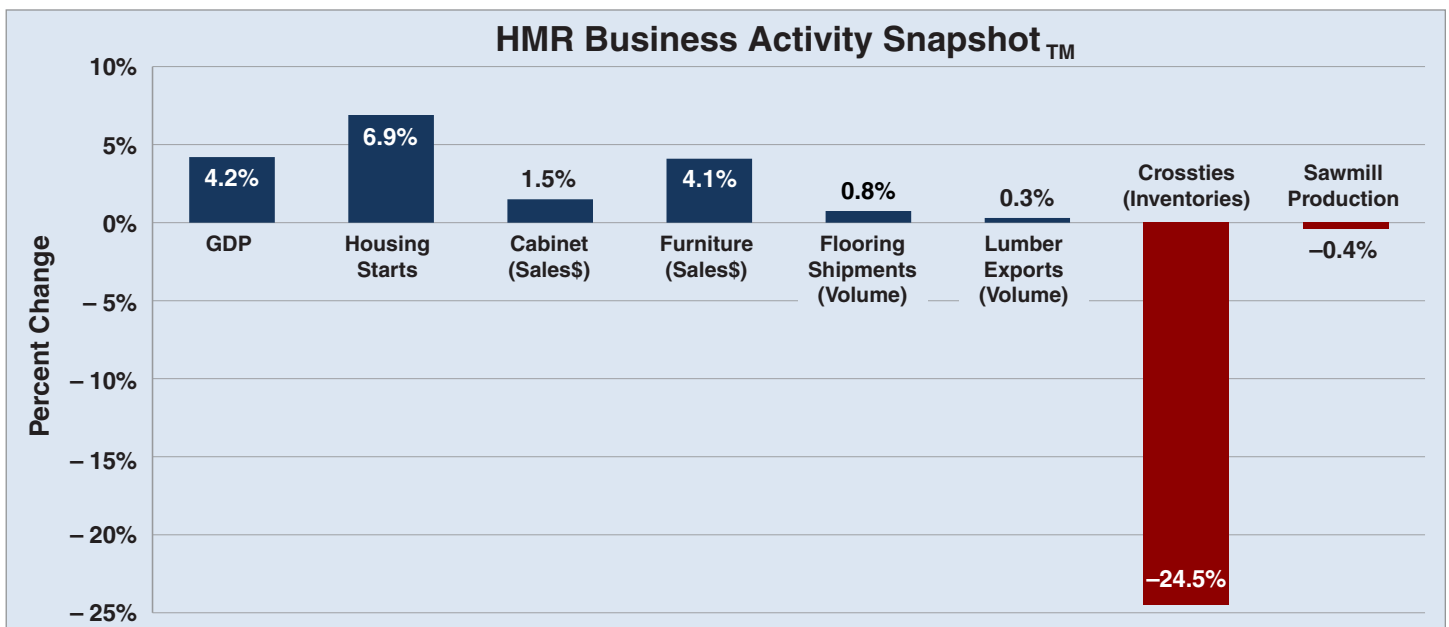
USDA Foreign Agricultural Service (FAS) data for hardwood lumber exports began in 1978. **Figure 1** shows principal foreign markets for the US from that point forward, based on volumes shipped. In 1978, most consumer wood products sold in the US market were manufactured domestically. The same was true for other mature economies. As with the US at that time, Canada and Europe manufactured furniture, cabinets, mouldings/millwork, flooring, and doors for their respective markets. Therefore, it was no coincidence Canada and the EU-28 comprised almost all US hardwood lumber exports through the early 1980s.

By the mid-1980s, Japan’s economy had grown exponentially. Japanese consumers’ desire for all things American expanded, including

- ✿ Real average earnings for all US employees climbed 0.1% in August over July and were 0.2% higher than one year earlier at \$10.78.
- ✿ US manufacturing capacity utilization was 75.8% in August, up from 75.7% in July and 74.4% in August 2017.
- ✿ In July, US consumer credit rose 5.1% over June; revolving credit grew 1.5%; and nonrevolving credit increased 6.4%.
- ✿ Retail sales in China advanced 9.0% in August 2018 over August 2017. For the January to August period, retail sales grew 9.3% in 2018 over 2017.
- ✿ Zillow’s Q3 Home Price Expectations Survey shows 76% of respondents believe the US housing market will remain a sellers’ market until 2020 or later.

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GDP – Q2 2018, Third est. **Housing Starts** – Y-T-D Aug. '18:'17, Unadj. **Cabinets** – Y-T-D July '18:'17, Unadj. **Furniture** – Y-T-D July '18:'17, Unadj. **Flooring** – Y-T-D Sept '18:'17. **Exports** – Y-T-D July '18:'17. **Crossties** – Aug. 2018 vs 2017. **Sawmill Production** – Y-T-D Sept. '18:'17.

valuable North American hardwoods. White Oak and Walnut were among the featured species. The only thing constricting higher sales volume at that time was availability. Japan’s share of exports climbed until the eventual collapse of its economy in late-1991.

As US furniture manufacturers looked for ways to control costs, especially labor costs, furniture production began the shift to Southern US states, then to Mexico. **Figure 1** highlights the steady increase in US hardwood lumber exports to Mexico beginning in the 1980s and peaking towards the end of the US housing boom in the mid-2000s.

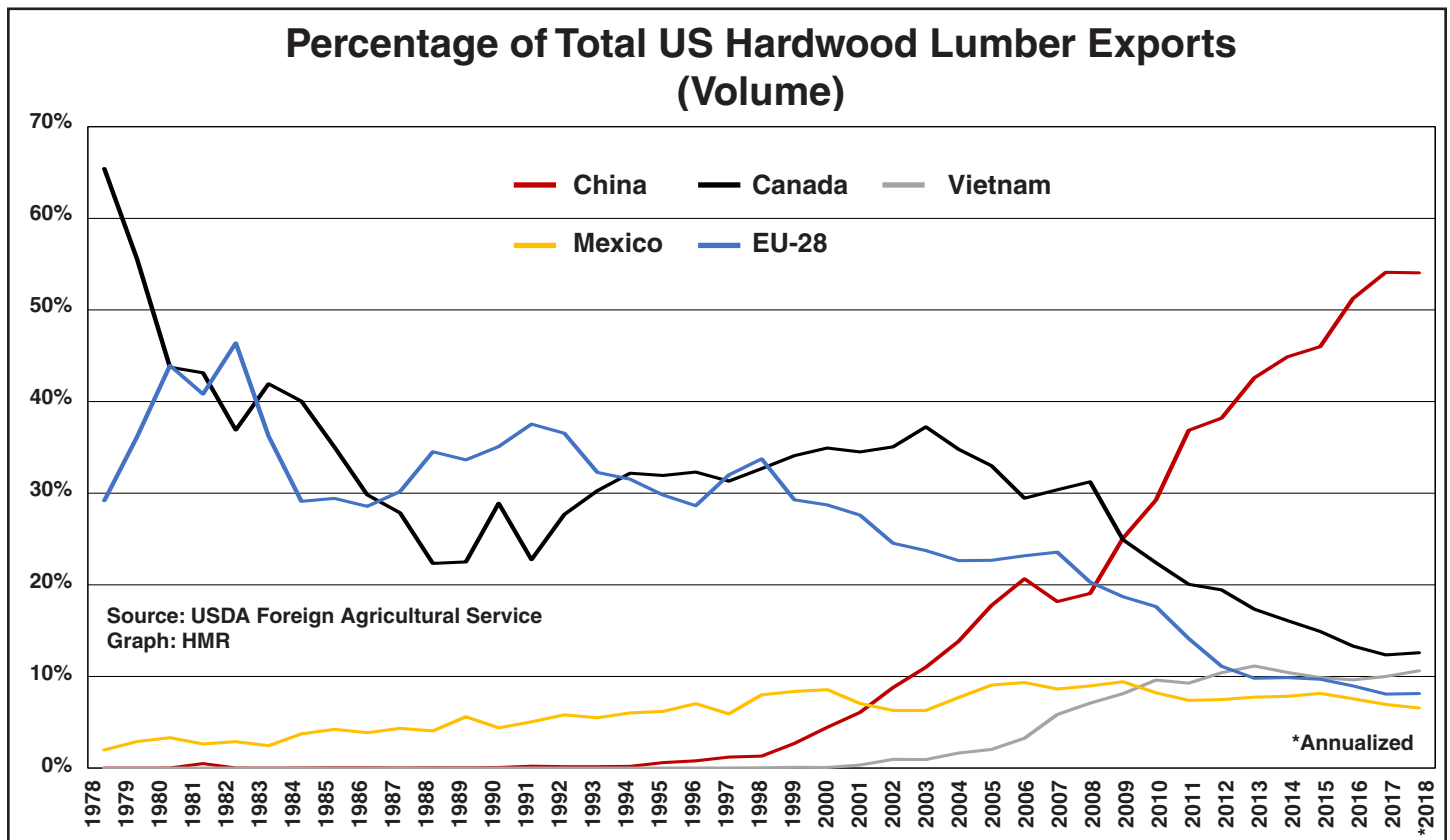
Migration of the US furniture industry eventually led to Southeast Asia. There was a desire to expand manufacturing and an abundant, inexpensive labor force available in the region. The evolution process began by outsourcing parts before US furniture manufacturing fundamentally relocated to China and the Greater China Region.

“Because of the manufacturing transition, there has been a significant shift in the species exported from the US.”

Hardwood lumber exports to Southeast Asia grew astronomically. Shipments to Vietnam accounted for over 10% of all US hardwood lumber exports through July 2018. Shipments to China first reached 10% of exports in 2011. Through July 2018, shipments to China comprised 54.1% of all US hardwood lumber exports.

Because of the manufacturing transition, there has been a significant shift in the species exported from the US. **Figure 2** exhibits the transformation through the years. From the late-1970s to the late-1980s, Red Oak and Maple were heavily traded across the US border to Canada. The EU-28 absorbed a portion of White Oak, Ash, and Walnut production. Global consumer fashion trends brought Cherry and Poplar to the world market.

Figure 1



As the US lost a majority of furniture manufacturing, other countries did not necessarily need US produced hardwoods to manufacture furniture – even those manufacturing furniture for the US marketplace. Tropical and temperate species processed outside of the US took market share from North American species. **Figure 2** shows Red Oak sales did not gain traction in international business until the early-2010s. Other developed countries were losing hardwood finished goods manufacturing to lower-cost labor countries, too, as evidenced by the decline in hardwood lumber sales to Canada and the EU-28.

Figure 3 points out the strong similarity between the rise of total hardwood lumber exports to China and the increase of Red Oak exports. Of course, China purchases a wide array of US hardwood species. **Figure 4** shows China’s importance to Cherry sales into foreign markets, accounting for 87.5% of all Cherry exports; Ash is second at 75.2%; and Red Oak is third at 74.7%. But,

the US exports far more Red Oak by volume than any other species, which leads us to the focus of this article.

What is going on in China, and why? It is not easy to find accurate economic data through the Chinese government. But, the second largest economy in the world garners much attention from investment companies and economists. Sorting through these reports provides a better understanding of the Chinese economy than Chinese government information.

A few things stand out. China is experiencing a housing bubble caused by overbuilding - similar in this regard to the one recorded in the US in 2006. But similarities end when comparing the scope of speculative building. A number of contacts who travel China regularly state that there are acres upon acres and cities upon cities of newly built structures sitting empty - ghost towns of buildings designed for residential and commercial uses that have never been inhabited.

Figure 2

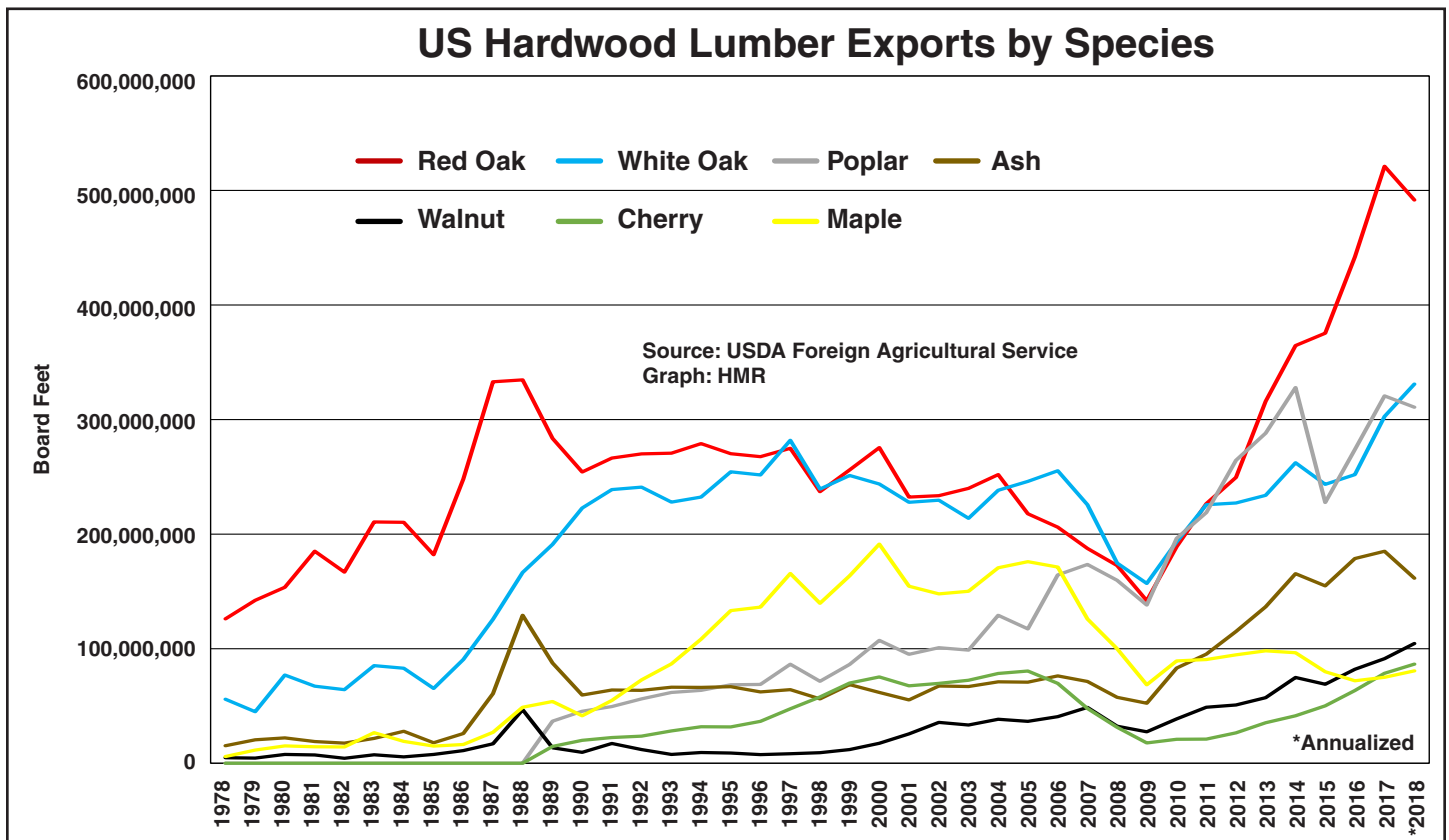


Figure 3

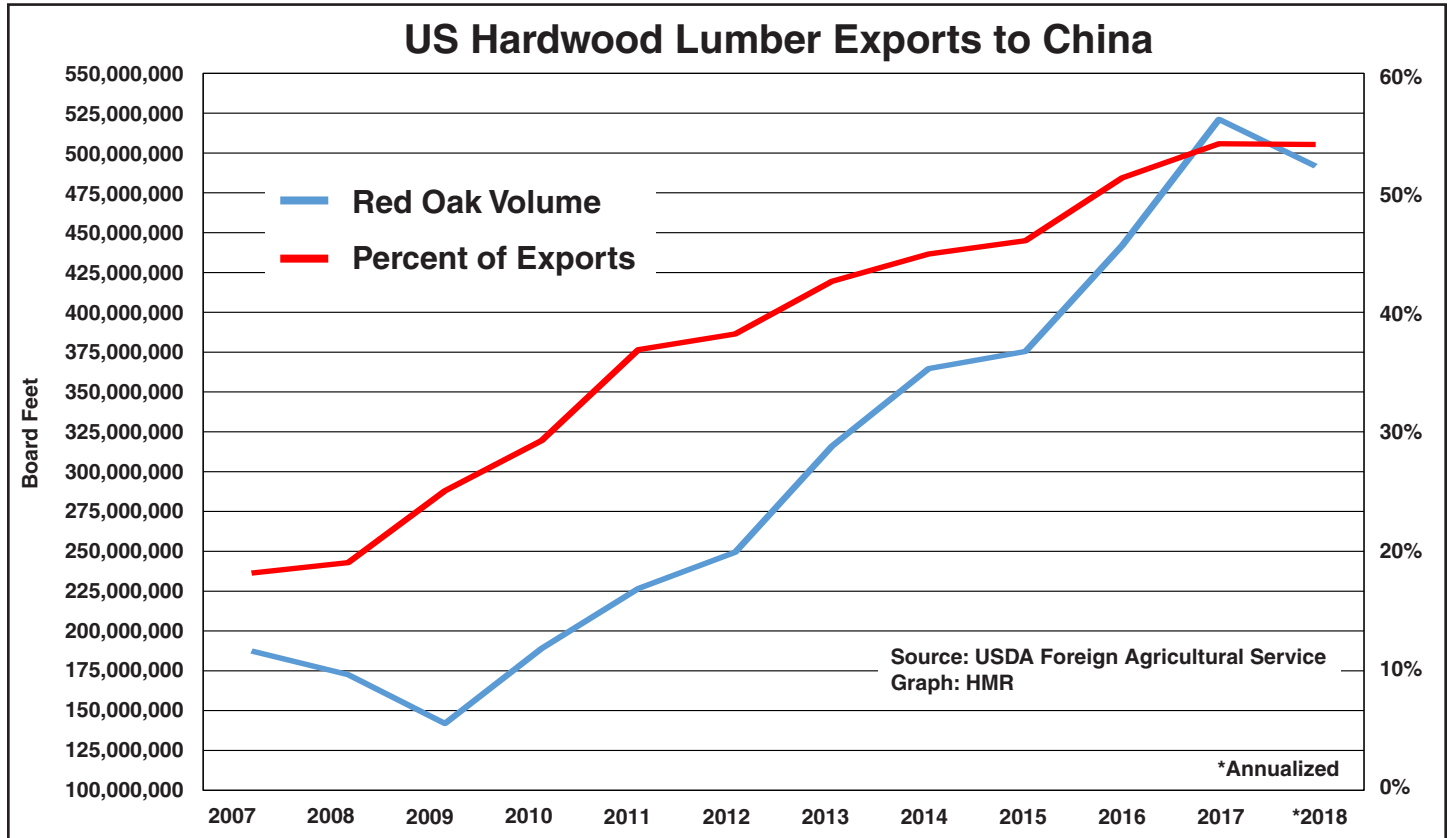
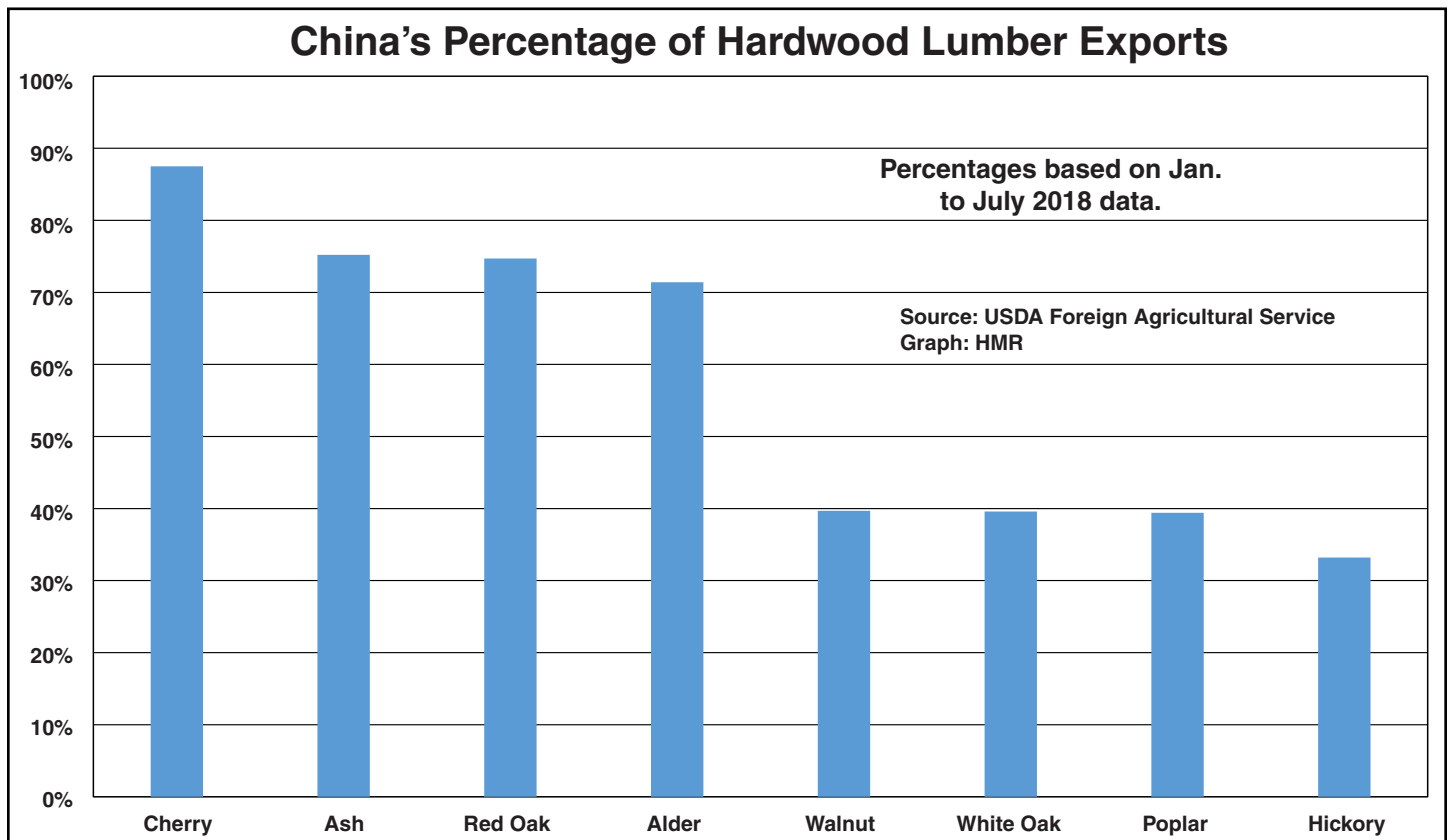


Figure 4



Richard Harris is chief executive of Port Shelter Investments. He recently penned an article, which provides relevant data on the Chinese economy collected by their firm and other sources. “Chinese GDP rose by a staggering 1,100 percent between 1992 and 2010. The global share of goods exports grew from 2 percent to 17 percent. Income per head rose 970 percent, 10 times faster than in the United States. A full half a billion people were lifted from rural poverty to middle-class comfort. No country in history has accomplished so much in so short a time for so many people.”

“China has shifted its focus away from investments and exports as a means of economic growth to pushing for higher domestic consumer consumption. That has been the driving force behind increased sales of American-produced hardwoods.”

Mr. Harris argues that China’s growth has maxed out, that it is now a developed economy, and growth rates will naturally slow. He points out that in this decade, GDP growth slowed from 10% to 6%, and that total investments and savings rates have declined. Additionally, the Chinese government debt has grown 52%.

The Chinese government understands the challenges ahead. China has shifted its focus away from investments and exports as a means of economic growth to pushing for higher domestic consumer consumption. That has been the driving force behind increased sales of American-produced hardwoods.

But, growing debt led the Chinese government to tighten fiscal policies to limit the flow of cash through the economy. Since Chinese consumers have decreased savings and cannot borrow for major purchases as readily as before, personal consumption expenditures have declined and will continue to weaken. Tightened money flow has also affected commercial activity by slowing growth or causing contractions. For the hardwood industry, the result is lower sales to Chinese end users.

That brings us to the problems at hand for the US hardwood industry. Many Chinese secondary manufacturers have excess finished goods inventories, and supplies continue to build. Solid wood flooring stands out in reports from industry sources. Nonetheless, sales of hardwood lumber have declined to manufacturers in virtually all market sectors. Businesses in any country have limits on the amount of money to invest, whether the investments are in finished goods or raw material inventories. But, China’s stricter monetary policies have altered the trajectory for US hardwood lumber business.

Now, the question is, how long will the downturn in hardwood business last? HMR surveyed subscribers for their perspectives. The vast majority of respondents believe the current downturn in business to China will last no more than six months. A number of Chinese distribution companies indicate total lumber inventories have declined significantly since July. They also state that there are ongoing sales and shipments of hardwood lumber to end users.

There is always a but. But, the Chinese government enacted a 5% to 10% tariff on hardwood lumber and logs in retaliation for the US government’s announced 10% tariff on \$200 billion worth of Chinese goods imported to the US. The tariffs took effect September 24, 2018. High-level US and Chinese officials were scheduled to meet to resolve problems with preexisting trade policies, but the announcement on tariffs derailed those discussions at the time of this writing.

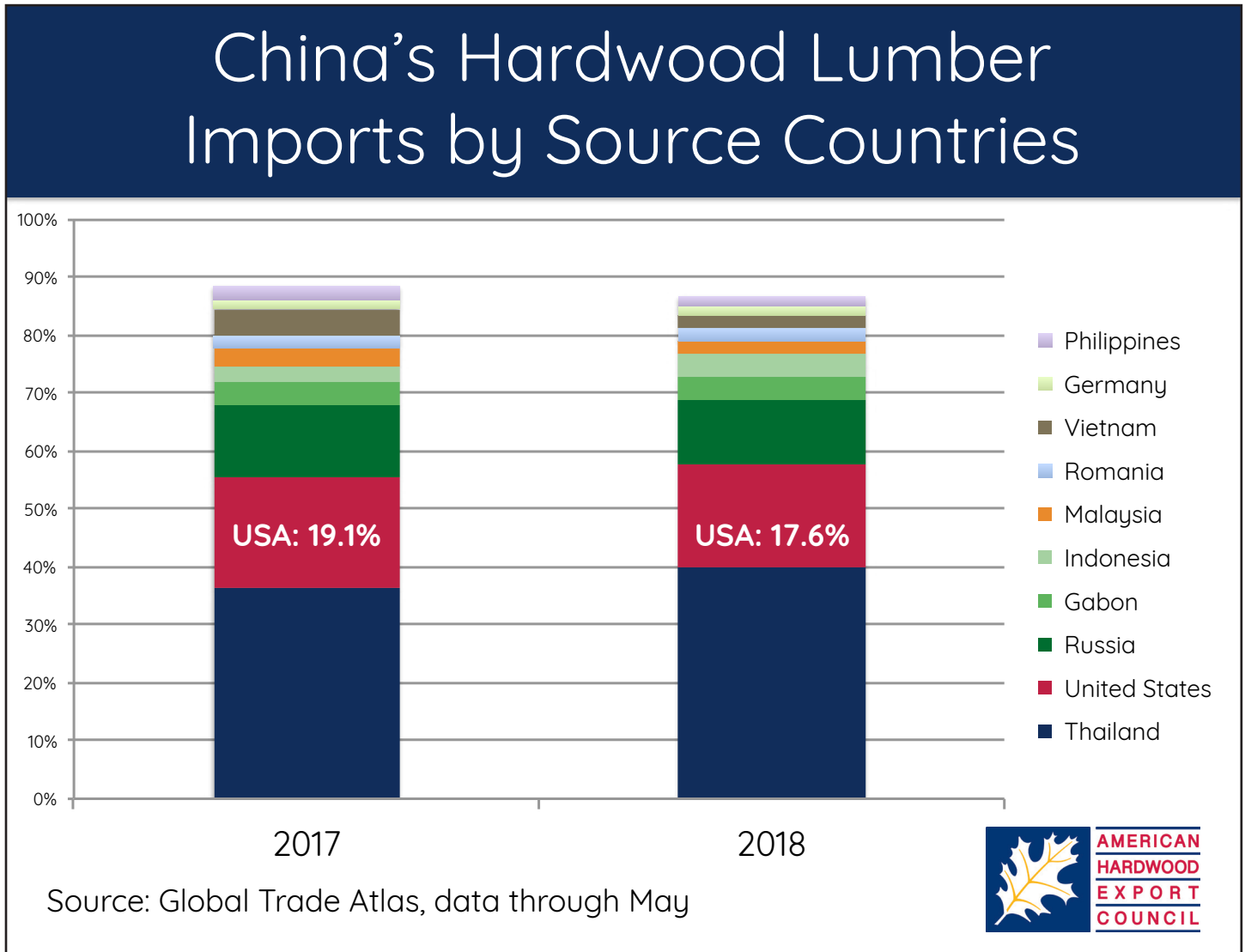
“... the hardwood industry is small in comparison to other industries affected by tariffs; it does not have much pull in these negotiations.”

For hardwood lumber, the problems are twofold. First, the hardwood industry is small in comparison to other industries affected by tariffs; it does not have much pull in these negotiations. Second, the US hardwood indus-

try is much more dependent on China than China is on US hardwoods. As mentioned earlier, China accounts for a disproportionately high percentage (54.1%) of all US hardwood lumber exports, which makes the US hard-

operating at high levels. The strong US economy and housing markets require substantial volumes of hardwood materials. Through mid-year 2018, domestic hardwood consumption was almost 6.8 billion board

Figure 5



wood industry extremely vulnerable to any disruption in this business. **Figure 5** shows China only purchased 19.1% of its hardwood lumber from the US in 2017; the percentage fell to 17.6% in 2018. Certainly, US hardwood lumber supplies are meaningful to the Chinese marketplace, but Chinese manufacturers and consumers have other sources and options for raw materials.

Most facets of the US hardwood supply chain are

feet (annualized), and exports were 1.9 billion board feet (annualized) (**see Consumption Chart on page 7**). Obviously, the US hardwood industry is highly reliant on international demand and China, specifically, for grade lumber business. Let's hope for continued global economic expansion (which is expected), a quick turnaround in China's monetary policies, and rapid implementation of a trade agreement mutually beneficial to the US and China.

Consumption Chart

Consumption of Hardwood Lumber by Major US Markets											
© 2018 HMR	Billion Board Feet									%	%
	2010	2011	2012	2013	2014	2015	2016	2017	2018	Change 2017	Change 2010
Pallets	3.2	3.26	3.27	3.643	3.685	3.589	3.265	3.063	3.237	5.7%	1.2%
Furniture	0.35	0.29	0.30	0.427	0.439	0.471	0.442	0.431	0.439	1.9%	25.4%
Exports	1.07	1.2	1.32	1.462	1.653	1.492	1.659	1.885	1.889	0.2%	76.5%
Millwork	0.43	0.24	0.26	0.387	0.394	0.406	0.428	0.473	0.469	-0.8%	10.4%
Cabinets	0.4	0.34	0.36	0.392	0.407	0.392	0.431	0.457	0.455	-0.4%	13.8%
Flooring	0.59	0.51	0.55	0.753	0.747	0.731	0.776	0.813	0.821	1.0%	39.2%
Railway Ties	0.89	0.98	1.04	1.114	1.032	1.08	1.091	1.057	1.024	-3.1%	14.9%
Board Road/Mat Timbers	0.198	0.243	0.267	0.424	0.413	0.318	0.357	0.368	0.372	1.1%	87.9%
Total Estimated Consumption	7.120	7.063	7.367	8.602	8.770	8.479	8.449	8.547	8.706	1.9%	22.3%



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