Gresham House
Forestry

How Many Economists does it take to Fell a Tree?

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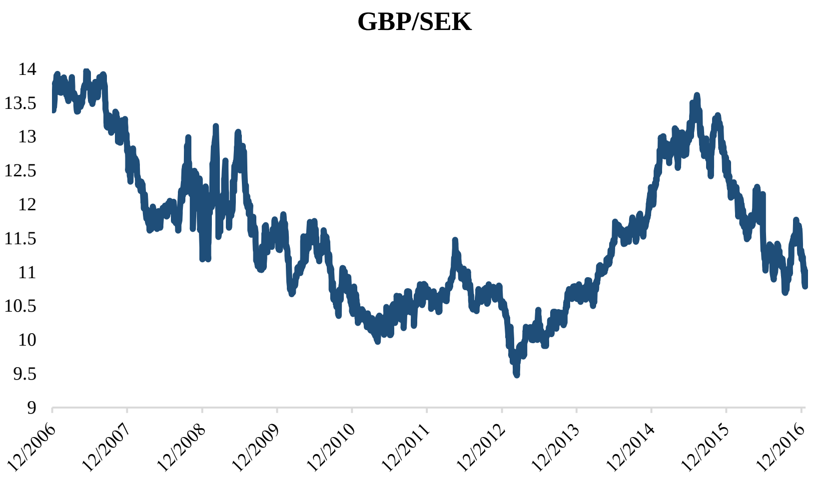
The outlook for the forestry sector remains good for 2017 despite economists' expectations of slower economic growth.

Taken at face value a survey of economists' opinions about the outlook for the UK economy in 2017 might be read as a tale of caution for cyclical sectors like timber and forestry. According to the Treasury's December 2016 survey of Independent forecasts, UK GDP growth is set to slow from 2.0% in 2016 to 1.2% in 2017. At the same time, CPI inflation is seen doubling from 1.3% to 2.8% and 10-year interest rates have already risen to 1.34%, with widespread expectations that they are going higher. The shadow of Brexit fears is being cast across the year!

So, it may come as a surprise to hear that timber prices finished 2016 at highs for the year. In fact, the latest sales have seen prices approaching to their 2014 peaks – in turn, the highest levels since the mid-1990s. Sawlog prices are now comfortably exceeding £60/tonne gross (before the cost of harvesting and haulage). What can explain the gap between economists' long faces and the smiles of the foresters? ..... and more importantly, who is more likely to be right ?

The first part to the explanation is that the GBP remains weak and its fundamentals weaker. The UK timber harvest, even though it continues to expand, accounts for only 25% of the 60m tonnes of timber used in the UK each year. While some of the 45m tonnes of wood product imports annually are undoubtedly not species or quality grades that could be successfully commercially grown in the UK, a large part of the imports are and much of that portion comes from Scandinavia. Therefore, a weak GBP against the EUR and Swedish Krone (SEK) is an important factor today in the strength of domestic timber prices – imports are being choked off and on our estimates the GBP would need to sustainably rise by 10-15% before reaching the levels against the EUR/SEK where imports would start to gain market share (i.e. GBP/EUR 1.30 and GBP/SEK 12.5-13).



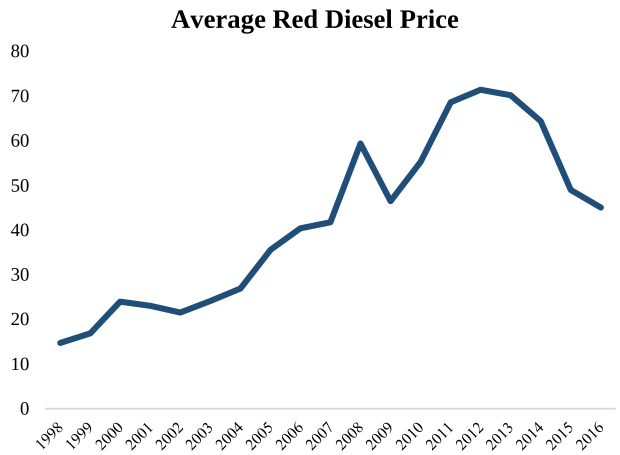
Given how far the GBP has fallen and the multi-year lows that it has hit on the way, we'd all be forgiven for thinking that a bounce is overdue and the only way is up for GBP. However, the things that I found over the years that I was in the investment world that really matter for currencies don't argue for any sustainable bounce soon, especially given the uncertainty over the direction of Brexit economic policy. There is no interest rate premium for GBP compared to other major currencies, little of a nominal GDP growth gap (i.e. UK is not growing significantly faster than others) and the

UK's capital inflow requirement as expressed through the twin fiscal and current account deficits looks horrific at over 9% of GDP. Furthermore, the GBP is today close to fair value against the EUR rather than undervalued on the OECD's purchasing power parity comparisons.

Taken together, I find it hard to believe that 2017 will be the year when the GBP has any negative impact on UK timber prices.

The second positive is found in renewed government commitments to housebuilding. The UK government set a target of one million homes to be built over the life of this parliament, in other words averaging 200,000 per year. If that is achieved in any single year, it will be the highest level of housebuilding that the UK has seen in a decade. For comparison, 2015 saw 143,000 houses completed. The timber content of new houses in the UK has been steadily rising and the market share of timber framed houses is expected to rise to 27% this year according to the Timber Trends Report, up from 23.6% in 2012. The government has re-emphasised this commitment at the beginning of this year with the announcement of the location of 14 "Garden Villages" totalling 48,000 homes – an announcement that sent homebuilders' share prices sharply higher.

Thirdly, while timber prices are back to their 2014 highs, fuel prices aren't. One of the biggest impacts on profitability in forestry is the price of harvesting and haulage, which in turn are significantly affected by the price of fuel. Red diesel (untaxed diesel for off road machinery usage) prices at the end of 2016 were 20% lower than the average of 2014 according to AHDB. This is highly significant in impacting the final net return received by the grower.



Finally, we mustn't forget that economists are often much better at explaining historical developments than forecasting future ones. While it may be correct to handicap forecasts of growth for this year due to the uncertainty over Brexit, **the few pieces of economic data that have genuine predictive ability are arguing the opposite and currently point towards GDP growth significantly surprising the economists on the upside**. What are these indicators? In particular, I would point to the fact that the yield curve (spread between 10 year and 3-month interest rates) is steepening, the new orders component of the December 2016 Markit/CIPS Purchasing Managers Index increased strongly to close to a 2 year high and the level of real interest rates is still anchored firmly below zero. If it wasn't for Brexit, I'm sure the consensus 2017 GDP growth forecast would have a 2 at the beginning rather than a 1.

As a final point, and more to do with forestry investment than timber prices. The consensus economist view in the Treasury survey shows that CPI inflation is expected to double this year to 2.8%. Historically, and not just in the UK, forest prices have acted as an inflation hedge by correlating positively with the rate of inflation – entirely understandable if the final product sale price rises in line or faster than CPI and investors shift out of financial assets into real ones as interest rates rise. UK forest ownership has generally been an area of little gearing so less subject to being squeezed when interest rates rise. Add this inflation hedge argument to rising timber prices and the potential for foreign capital to be drawn into buying discounted UK assets and UK forestry still seems to have the wind at its back.