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Technical: McClellan Chart-In-Focus March 22, 2019

How Lumber Lost Its Mojo As An Economic Indicator

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eResearch Corporation is pleased to provide a weekly commentary, authored by Tom McClellan, entitled "The McClellan Chart-In-Focus", which is a free technical analysis article published each week.

In this article, Mr. McClellan looks at the price of lumber and notes that it is out of step with other associated price indexes.

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March 22, 2019

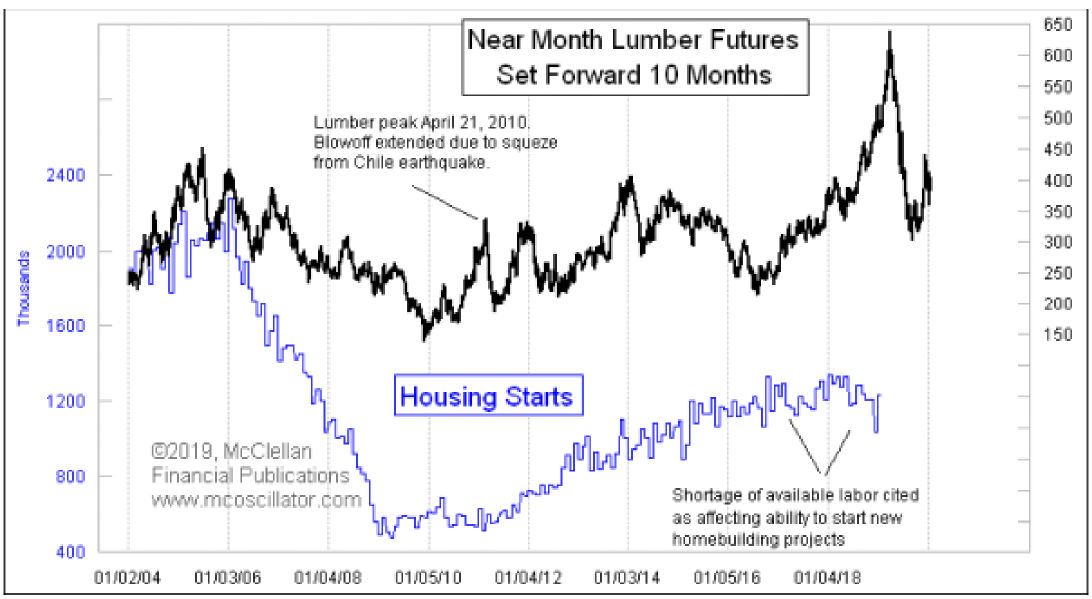
The McClellan Chart-In-Focus

by Tom McClellan (bio at end)

How Lumber Lost Its Mojo As An Economic Indicator

For years, the price of lumber futures has been a pretty good leading indicator for a variety of economic data, especially the series related to the housing market. But recent events have caused lumber to not be a good leading indicator. It is likely just temporary, and, hopefully, lumber will get back to being a good messenger about what the future holds. So, we should not expect the data on U.S. housing starts in this week's chart to echo lumber's big blow-off top.

Housing starts data usually follow the dance steps of lumber prices with about a 10-month lag. This is some of the magic of what lumber prices used to be able to reveal. The lumber futures market had an ability to sniff out future trends in the economy ahead of time, and reveal those in its movements. But when exogenous events like the 2010 earthquake in Chile put a thumb on the scale of lumber prices, then the message from those prices is not as useful.



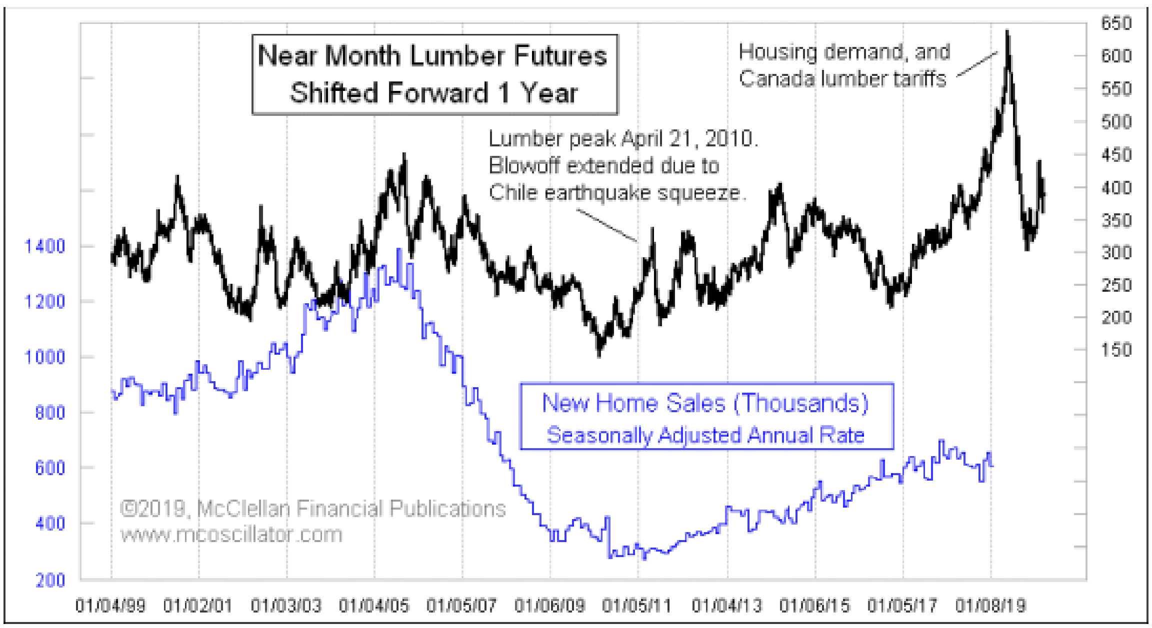
In April 2017, the USA imposed a tariff on Canadian softwood lumber of 20%-25% (depending on the location of the Canadian producer), in response to subsidies granted to the lumber industry by the Canadian national government as well as provincial governments. That followed the October 2015 expiration of the U.S.-Canada Softwood Lumber Agreement, as well as the expiration of a 1-year moratorium on trade actions following that expiration. Despite efforts from Canadian and U.S. trade representatives to reach a new deal, no new agreement has been achieved. Canada has claimed that the tariffs violate the terms of NAFTA, and has escalated the complaint to the WTO, but that body has not yet ruled.

The imposition of those tariffs set off a big squeeze in the lumber markets across the U.SA.., as major consumers of lumber such as homebuilding firms scrambled to lock in sources for the 2x4s and other sizes that they needed for their upcoming projects. They sought to lock in pricing in the futures market, causing a classic blow-off which drove up prices far more than the amounts of the tariffs. That caused lumber futures prices to nearly double from the moment when the tariffs were imposed.

Like any blow-off top, there had to be a corresponding collapse, just to satisfy nature and balance things out. All of this constituted the same sort of exogenous event as the 2010 Chile earthquake, but on a much grander scale. As a result, it makes the last 2 years' price action in lumber worthless as a leading indication.

The whole point of the leading indication is to get messages about the future state of the economy based on what economic forces are doing to lumber prices. But when prices are not moving based on those economic forces, but rather based on exogenous events, it is like shooting the messenger.

Lumber prices typically also lead new home sales by about a year: [see next chart]



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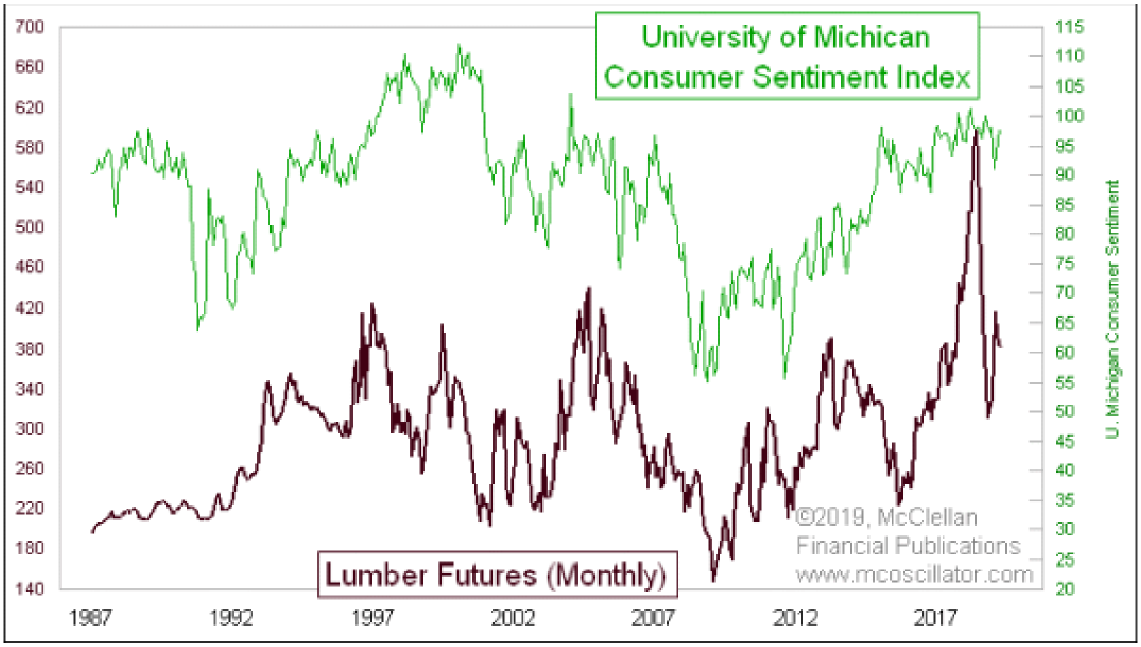
One of the most interesting correlations of all is how lumber prices move in step with consumer sentiment, at least most of the time. Here is a comparison between lumber futures and the University of Michigan's Consumer Sentiment Index:



As with the other relationships to lumber prices, this one has been wonderful right up until the big blow-off. There is no way that consumer sentiment can see the same degree of excess, and so it does not. Nor does sentiment feel the big collapse that lumber prices have displayed. It is best to just put your thumb over that part of the chart.

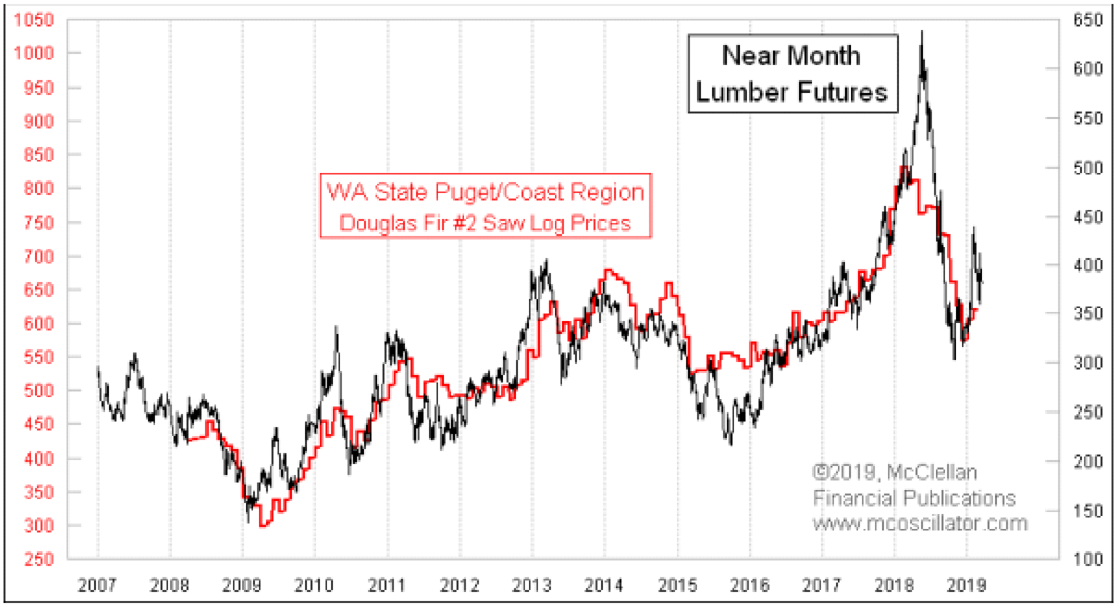
My estimation is that for about the next year or so, lumber's economic message is effectively worthless. It is very much like how the surf forecast for Southern California beaches is normally very reliable, except on the day when the asteroid falls into the ocean. Eventually the waves will return to normal, and answer to the forces of wind and tide, but the tsunami has to get done first.

The magnitude of the lumber futures market blow-off even becomes evident when we compare it to what timber prices were doing. As an aside, "timber" refers to the raw logs, either standing in a forest of just freshly cut. To turn timber into finished lumber, you have to add cost factors for transportation, labor, fuel, electricity, and capital costs.

See next chart.

<continued>

Here is a comparison of lumber prices to western Washington timber prices:



The two plots usually move in lock-step, which is as one would expect. Higher lumber prices mean that mills are willing to pay more to buy logs. But things got interesting in the spring of 2018. Timber prices peaked in February 2018, and lumber made an initial peak in step with that timber price peak. But then lumber futures swooped up another 23% to an even higher blow-off peak, while timber prices were declining. It was the timber market's way of saying, "Nahhh, we ain't buying this blow-off."

Now the two are getting back in sync again, or so it seems, which gives us hope that, eventually, the lumber futures market is going to be a legitimate indicator for the economy again. But until we see evidence that things are back to normal, lumber cannot be considered a reliable economic indicator.

Tom McClellan, Editor,

The McClellan Market Report

BW: Information on Tom McClellan and *The McClellan Market Report* and *The Daily Edition* is provided on the following page.

ABOUT THE AUTHOR

Tom McClellan

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for inter-relationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point, where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of certain indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts.

In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and his Father spent the next two years refining their analysis techniques and laying groundwork.

In April 1995 they launched their newsletter, The McClellan Market Report, an 8-page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A Daily Edition was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds, and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA.

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