Containerboard Market Faces Uphill Battle

In one of the fastest turnarounds in history, containerboard markets did a U-turn in fourth quarter 2008 as demand collapsed in the face.

By Harold Cody

The economic tsunami that has swept across the U.S. and around the globe has had a substantial impact on almost all major sectors of the economy. While high profile problems in industries as diverse as autos and financial services have garnered the most attention, the U.S. containerboard industry has been similarly hard hit. The suddenness of the downturn in box markets, which before September showed little sign of the impending disaster, is one of the most notable aspects of the decline. It's just incredible how fast things changed.

Corrugated box demand has historically been viewed as one of the best indicators of the health of the U.S. economy. Box cut-ups closely track industrial production. For most of 2008, box and containerboard markets held up relatively well. Shipments were flat, which paralleled the track of industrial production, despite growing concern about the economy. Pricing, which had been driven up by rapid cost escalation for energy and fiber earlier in the year, remained strong until some modest discounting late in the year after the box market fell apart. As late as August, box shipments had held up surprisingly well. August shipments were down 4.6% vs. 2007 levels, but on an average week basis they actually increased due to two fewer shipping days.

Shocks Hit Buyers, Converters and Board Mills in September

In September, this all changed as the hammer fell. By the fourth quarter of 2008 demand was in a freefall as a massive wave of uncertainty finally hit hard, and consumers and business pulled in the reigns. Business simply evaporated and markets were thrown into turmoil. Corrugated shipments fell 14.4% in November, and year-to-date were down 3.8%. This was on the heels of a nearly 9% drop in October. Shipments fell 1.4% in 2007 to 389.5 billion sq. ft. Even in prior recessions the change was much less sudden.

Obviously weakness in the overall economy was the culprit driving these precipitous declines. The first clear indicator of underlying trouble was the large drop in industrial production in September, which fell 4.1%, which is simply huge. Industrial production was weak in October and fell modestly in November. December is likely to post a large drop as well. Nevertheless, it is simply amazing how quickly the box market turned. While box demand follows industrial production, declines are generally more moderate in pace due to the widespread use of corrugated boxes throughout the economy. Typically, large ticket durable goods demand declines more rapidly and box demand for this sector shrinks. However, other major box markets including food and paper products that also typically slow or contract during economic weakness normally are less volatile. While consumers might put off buying an appliance, they certainly can't simply stop buying food, which is a major user of boxes. It appears that the contraction in economically more sensitive sectors was simply so large and sudden that it masks more moderate declines in other sectors.

Prices have yet to fall dramatically in response to the weakness in box and containerboard markets, but the steady gain in prices that had been sustained since the upward trek began in 2005 is at an end. Following the last successful increase in mid-2008, prices surged to over $600/ton after holding at about $550/ton for most of the previous 12 months. Shifts in currency helped support pricing in the U.S. by helping U.S. exports.

2009: A Disaster or Just a Big Adjustment?

The crystal ball is certainly cloudy as we all try to look forward. We do know that the economic outlook for most of 2009 is bleak. Right now a relatively optimistic (remember, I said optimistic) outlook for the economy according to many economists is for GDP to contract further in the first quarter and be flat in the second quarter, followed by minor gains in second half 2009. This would mean GDP showed no growth for four quarters. Thus, box demand is unlikely to post positive gains any time soon. Even if box demand falls in Q1 2009 at half the rate of decline posted in late 2008—say at 5%—this means box cut-ups will fall by over 15 billion sq ft on an annualized basis. Despite box plants taking large chunks of downtime to offset this decline, pricing will certainly weaken. Containerboard prices are likely to fall $50 to $60 per ton, thus rescinding the last increase of 2008. The big question is whether or not mills can escape a more drastic drop that culminates with prices falling to cost.

The only good news—if you can call it that—is that containerboard mills have responded to the sudden shift in business conditions with the same speed and efficiency we've come to expect. An extensive amount of downtime has already been taken and significant closures going forward have been announced. About 1.4 million tons of capacity was curtailed in the fourth quarter of 2008, or about 15% of U.S. containerboard capacity. This dropped operating rates to 85% in November, which is the lowest level in recent memory. U.S. output of paper and board plummeted 13% in November and is down 3% year-to-date.

In turn, this fast and massive response will have hopefully held box plant board inventories under control. December containerboard inventory data are likely to show a considerable decrease despite the fall in box plant consumption. So far, this certainly has helped control the erosion in prices.

Some observers note that with a much higher level of industry consolidation—the top four hold almost 70% of capacity vs. half that level a decade ago—producers are better positioned to weather a downturn and hold pricing. However, with demand in a freefall it will be very difficult to stay ahead of the curve.

Last year the export market was a key factor supporting price gains and holding up mill output even as the U.S. box market remained lackluster. Linerboard production for export surged in September just as the domestic market weakened, jumping 19% vs. the prior year and up over 9% for the year at 2.6 million tons. However, November exports were off 13%, the first drop in exports in 2008, and with the global economy now in a major downturn, its unlikely export tonnage can continue at recent levels. Export pricing has also weakened considerably.

Put this all together and one relatively rosy scenario would have the U.S. and other major economies stumbling through a difficult period until mid-2009. By then all the moves by the Federal Reserve and government policies of 2008, combined with the new administrations stimulus efforts, would begin to work and usher in a very modest recovery beginning in the second half of the year.

The key for mills is to avoid a price collapse to the point that even the mills still running aren't making money. This economic outlook certainly could be overly optimistic, but to be honest, I don't think anyone really knows. Since we haven't seen an economic mess like this in decades it's hard to predict when box demand will stabilize or how fall prices can fall. ■

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