Containerboard Markets Sail Smoothly Along Despite Storm Warnings All Around

Box and containerboard markets have been unusually stable for well over a year despite global economic turmoil and continued sluggish growth in the U.S. Will this uncommonly long period of stability come to an end in 2012 or can the industry continue to display the remarkable balancing skills exhibited since mid-2010?

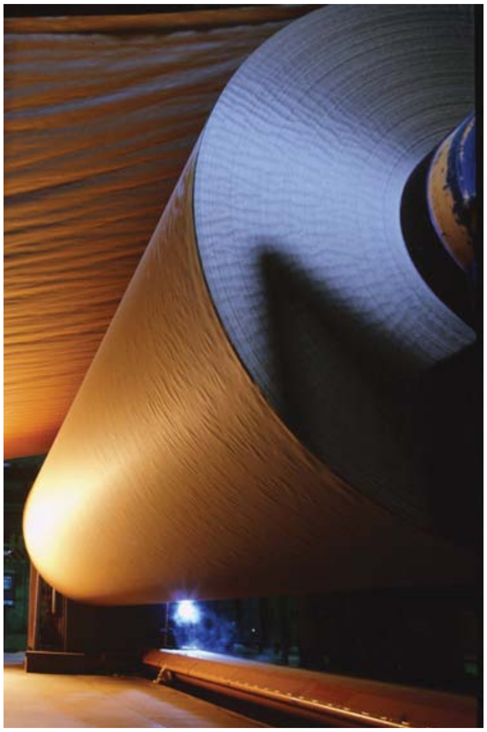
By Harold M. Cody

North American containerboard and box markets have been running smoothly along for over a year and a half like a ship sailing through a dead calm sea. The ride has been nice and smooth with little up and down motion — in prices, output, operating rates, etc. What's really amazing is that the seas around our proverbial ship have been anything but calm.

The world economy remains uncertain owing to a huge cloud hanging over Europe from the debt crisis that threatens to wreak havoc not only in Europe but potentially overseas as well. And while the U.S. economy has grown, high unemployment and the worst housing market in a generation continue to wreak havoc on millions of households. So how have containerboard markets remained so steady and more importantly can it continue?

A look at market fundamentals sheds some insight into how this long run developed. First, it is readily apparent that the smooth sailing has not been the result of a strong recovery in any basic driver of demand such as domestic demand for containerboard or corrugated boxes or strong growth in the U.S. economy.

The U.S. economy continues to plod ahead, and while fear of a double dip recession in 2012 appears to have subsided, growth has been less than stellar. Real GDP growth has been weak, rising 1.8% in the third quarter of 2011, the most recent. This tepid growth was actually an improvement over growth in the first two quarters of the year, when GDP rose 1.3% and 0.4%, respectively. In 2010, real GDP rebounded and grew 3.0%, ending a two year decline, including a 3.5% drop in 2009. Strong U.S. exports have been of some help overall and as covered later this has been particularly true for linerboard.



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In contrast, Industrial Production (IP), a general indicator that relates more closely to box demand, has been steadily improving, rising 6.1% in third quarter 2011, the ninth straight quarterly increase. IP rebounded in 2010, rising 5.3% and ending a two year slide. In November 2011, IP fell by 0.2%, the first decline after six straight monthly increases. However, the nondurables sector which includes the key food segment, a major box market, remains weak and output has fallen for each of the last three quarters.

In response to a sluggish and uneven economy, box demand has been flat. U.S. box shipments through November 2011 were 329.8 billion sq. ft. (BSF) up 0.5% compared to year earlier levels, reports the FBA. This equates to an annualized rate of 359.8 BSF. U.S. box shipments have rebounded from the bottom reached in 2009, when they fell to the lowest level in decades at 345 BSF. Last year, shipments hit 357 BSF but they remain well below much higher historical levels, which exceeded 400 BSF in the late 1990s and the 390 BSF level attained during the 2004-2007 period.

As has been the case for some time, linerboard exports have been a key piece of the recipe for smooth sailing. Export tonnage has continued to provide underlying support to help offset a lack of significant domestic growth. Export linerboard production remained essentially flat in November 2011 at 304,000 tons, bringing year-to-date export shipments to 3.4 million tons, a 6.4% gain over the prior year level, and equate to an annualized rate of 3.77 million tons.

These gains continue to provide much needed support to containerboard production levels that result in strong operating rates — well over the level required for a balanced market. Containerboard production in November was up 1.6% and overall containerboard production through the first eleven months was running 0.3% over last years' level at 31.2 million short tons, according to AF&PA data.

Exports continue to be an area of strength for North American mills due to two key factors: a low global cost position and a continued need for virgin fiber content in the global fiber mix. About 70% of North American production is virgin Kraft liner content, compared to 30% of world production, and essentially zero of the production in China, which is all recycled. Liner exports now represent over 21% of production, vs. just about 15% ten years ago.

Supply side management has also been important. When the economic recession hit in 2008-2009, producers responded with permanent capacity closures that were a huge contributor to maintaining a healthy balance. Over the last three years, about 3 million tons of North American capacity, or about 7% of capacity in place prior to the economic recession of 2008-2009, were closed. This includes over 2 million tons of liner and almost 900,000 tons of medium capacity, with most of the closures in the 2008-2009 period. These were partially offset by some incremental additions, but the net decrease was still about 6%.

In turn, operating rates have been favorable, running very high in late-2010 before easing a bit in early 2011 but remaining solid. Beginning in August 2011, operating rates improved to over 95% and in November were 95.8% for linerboard and 96.1% for overall containerboard. Inventories remained low as well in November at 2.3 million tons for mill and box plant combined.

With supply and demand remaining in a healthy balance and tipping to favor producers, linerboard prices have been steady for well over a year. Prices rose steadily from the bottom reached in 4th quarter 2009 and reached $640/ton in second quarter 2010, where they essentially remained to the end of 2011, one of the longest such streaks ever. Medium prices have held steady over the same period at $610/ton.

Rising cost inputs notably for OCC have been a concern for mills and also one factor helping to sustain containerboard prices. In 2009, OCC prices fell to under $100/ton — one of the lowest levels in years — then rose substantially in 2010 to about $160/ton due to strong export demand. Prices reached the $170-$180/ton range in 2011 according to various industry sources, but as of late, OCC prices dipped by $40 to $50 per ton as the export market slowed marginally.

The question now is whether all of the factors that aligned to keep supply and demand in a narrow range of balance will continue in 2012. It appears a big surge in domestic box demand is unlikely to provide an added boost. Most 2012 economic forecasts are subdued, in part because of the huge uncertainty hanging over the economic outlook in Europe. While box demand has risen incrementally, overall sluggish U.S. economic growth remains a formidable barrier.

Common wisdom is that prices will slip a bit over the seasonally slower winter months, i.e. into the first quarter 2012 due to several factors. Exports appear to be weak in the short term, due both to sluggish demand in Asia and aggressive marketing by producers such as those in Europe and cost pressures are easing due to lower OCC prices. With domestic demand sluggish, prices may slip $30-$40 per ton.

Going forward, the devil will be in the details. Much of it centers on producers being able to continue to closely manage supply and avoid a run up in inventories. If they succeed, 2012 could be another solid year despite the huge amount of uncertainty about the global economy. U.S. mills will continue to be the low cost producers, and thus exports should continue to be a key outlet. While Asian demand has weakened recently, it's likely just a typical pause in orders caused by a year-end drawdown and the drop in export prices.

U.S. demand isn't expected to register any large gains, but at the same time steady, albeit incremental growth is likely to continue. After an initial weakening early on, 2012 could be another solid year unless the European Euro crisis pulls the global, and U.S. economy, into a tailspin. The recipe may still continue to work. ■

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