Pulp Supply Curtailments Allow Producers to Run the Table

The closure of cash-starved pulp mills in Canada started the ball moving and it's been rolling for all of 2006. Dwindling supplies and global demand growth have combined to produce one of the strongest pulp markets in years, and things look rosy for mills into 2007 despite weak North American demand. A combination of new capacity coming on-line in 2007 and restarted capacity in North America appear to be one thing that could throw water on the fire next year.

By Harold Cody

In last fall's column I commented on the complexity of analyzing and forecasting the market pulp business. Shows what I know. Since late 2005 a strong bull pulp market has resulted in a series of price gains that have pushed prices to levels not seen since the 2000-2001-peak and recently to record levels. And once you cast aside all the numbing pulp statistics you can use to analyze the market (inventories, days of supply, operating rates, shipments, costs, currency rates, etc.), the real reason the market has been so strong is simple and something taught in Econ 101. It all boils down to supply (low) and demand (high). There is too little pulp chasing after what is apparently solid and growing market pulp demand. Given this, pricing momentum has been all on the producer's side for months and there is little to indicate it will turn much anytime soon.

The underlying reasons behind the supply and demand situation, however, are a bit more complex. Global pulp markets have been experiencing very strong pricing momentum due to a number of capacity curtailments and growing pulp demand. The supply curtailments that enabled the current tight market have been concentrated in Canada, and to a much lesser extent the U.S., and about 1 million tons of capacity has been pulled off the market. This includes temporary and permanent closures by Domtar, Weyerhaeuser and Neenah. World softwood capacity is estimated to have decreased about 2.5% in 2006, while hardwood capacity has increased.

The reason behind the capacity reductions is that Canadian mills, particularly eastern mills, were bleeding red ink during the latter part of 2005 and into 2006. Initially, pulp prices fell during a weaker period early in 2005 until they reached a trough in September. However, the situation was aggravated to a great extent since at the same time the Canadian dollar strengthened. Thus, for example, while pulp prices in dollars rose strongly over the September 2005 to May 2006 period, Canadian dollar prices rose only modestly —owing to the rising value of Canadian currency—and Canadian mill net realization prices were terrible. This situation did change during 2006 as in May the Canadian dollar fell back as dollar prices continued to rise. The return to profitability for Canadian mills, which began in the third quarter 2006, may lead to the re-start of some of the idle capacity, so it's something to watch.

Bales of pulp loaded on railcars at Rottneros Mill in Värmland, Sweden.

Global Demand

As noted in last fall's column, Asian demand continues to be the key factor influencing global pulp markets. Global pulp demand has been increasing modestly since the global economy is improving, and it's improving in many regions at once. But demand improved despite essentially no demand growth in North America and modest growth in Europe because Asian demand has skyrocketed, rising to 6-7 million tons last year, according to various estimates. About one-third of this was supplied from North America.

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Demand for printing and writing papers, which consume about two-thirds of market pulp demand, has grown only abut 1.5% in the last five years, rising under 1% in mature economies, but surging about 6-7% in areas such as China, Korea and other developing areas. Demand in mature economies such as North American and Europe only rose about 0.5% over the same period, falling in North America while rising 2% in Europe. Tissue demand continues to post solid gains including in North America.

As a result of all of this, global producer pulp inventories stood at 29 days' worth of supply in September, down from 31 days the previous month and 34 days in September 2005. Meanwhile, the operating rates continued to climb month-on-month, rising from 93% to 97%. These are levels that indicate a tight market, thus the continued run up in prices into the fall of 2006.

Outlook

The outlook continues to be very positive for 2007. A blip could occur near year-end as demand eases a bit and as lbuyers anticipate the impact of a considerable surge in hardwood capacity due online in South America.

However, Chinese pulp demand will continue to be a major driver of pulp demand, as the huge and growing Chinese paper industry is highly reliant upon market pulp. This bodes well for the outlook into 2007 as paper production in China will continue to expand both to meet growing domestic consumption and increasing to supply fiber needs for paper to be exported from world-class mills that are becoming a majority of the Chinese industry.

Prices have likely reached the pinnacle or close to it and they may retreat some in the face of capacity growth. But next year appears to likely be a good to possibly great one for most mills. ■

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