Pulp Market Bulls Look to Keep Running into 2008

A strong bull pulp market running for almost two years doesn't appear likely to end anytime soon. Capacity withdrawals initiated the current upswing which began in early 2006. Strong demand coupled with recurring supply disruptions continues to sustain the strongest market in years as prices hit new highs. Unless the U.S. economy sours, new South American capacity coming on-line is about the only thing that could turn down the heat.

By Harold Cody

Not much has really changed over the last year in the pulp market. Prices keep rising, demand remains solid and exchange rates are having a huge impact on the producers and the market. This is pretty much the situation reported in our last market pulp column in the fall of 2006. Since then producers have benefitted from several months of rising prices and good demand. Of course, as noted below, Canadian producers certainly have a different view of the market but for most mills 2007 has been a good year that followed a good year.

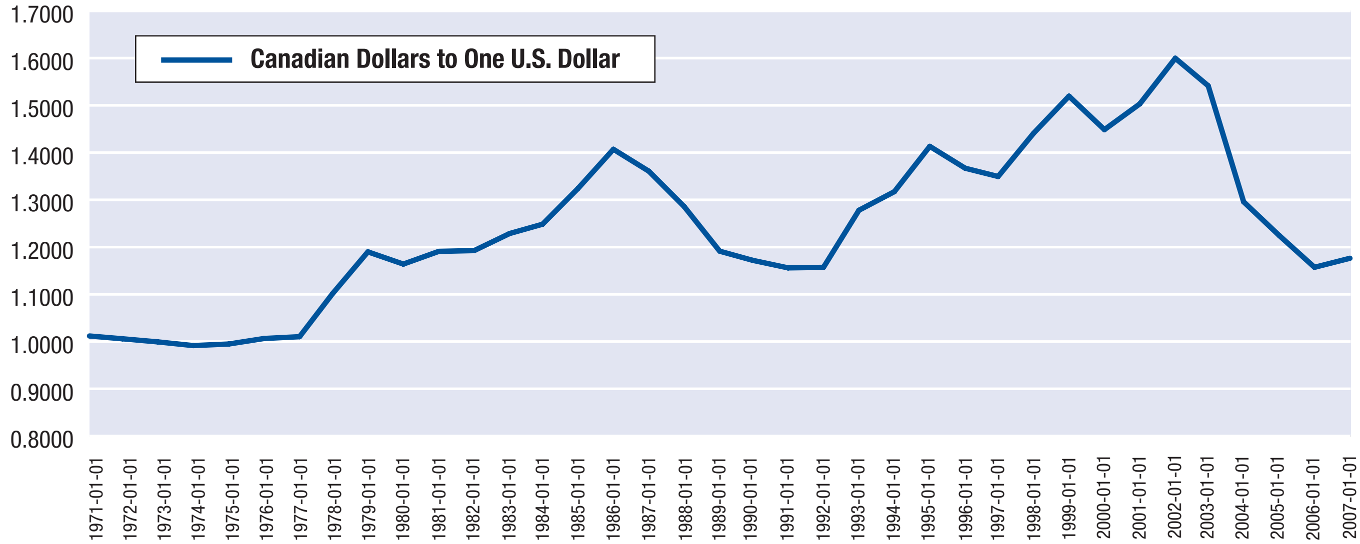
Pulp prices again rose in early fall and producers have announced another increase effective with Nov. 1 shipments. If it is enacted—which appears likely—NBSK would reach $870/tonne in North America (and $850/tonne in Europe). Prices have now risen steadily since late 2005 based on strong underlying market fundamentals including strong demand, modest stocks and limited supplies. During this strong "bull" market prices have surged to levels far above the last peak in 2000-2001.

Southern Pulp. Global demand for pulp continues to rise and new mills in South America are in hot pursuit.

Global market pulp producer inventories stood at 29 days' worth of supply in September 2007, down one day of supply vs. the prior period. The current levels are in line with historical inventory levels, and generally seen as a positive indicator for producers. Global market pulp shipments in September were up slightly year to year at 3.33 million tonnes, with softwood Kraft shipments declining to 1.7 million tonnes while hardwood Kraft shipments rose to 1.46 million tonnes, according to the Pulp and Paper Products Council.

View of Exchange Rates in Eye of the Beholder

As reviewed in detail in our fall 2006 market pulp column a significant industry restructuring has been a major factor behind the run up in prices and market strength. Over 1 million tons of capacity was permanently shut down in 2006 alone. And the key factor driving this restructuring, which was focused mostly in Canada, was the unprecedented run up in the Canadian dollar. With pulp sales denominated in US dollars and costs in Canadian dollars, a wide range of Canadian producers were running in the red and simply ran out of money. Even as pulp prices were rising, the more rapidly rising value of Canadian currency resulted in terrible Canadian mill net realization prices. The situation eased off some in the second half of



2006 and even began to look like things might get better. But they didn't. In fact it got even worse beginning in the second quarter of 2007 and by October the Canadian dollar had reached parity with the US dollar and put even more pressure on Canadian mills. This also makes it unlikely that any of the idled capacity can be brought back online and has led to even more closures and bankruptcy filings.

Of course, the main news on exchange rates is the crisis they have precipitated for many Canadian pulp, paper mills and board mills. However, it's a different case for U.S. producers. For them, exchange rates are working in their favor. The Euro has now fallen to just 0.70 Euros/dollar, making US pulp cheaper in Europe. At this time last year, the exchange rate was about 0.80 Euro per dollar. This is good news for North American producers of pulp, paper and board.

Another Good Year in 2008

The market outlook continues to be bright for the remainder of 2007 and into 2008. Capacity is flat to declining in North America and not much better in Europe. The exception continues to be some large new capacity projects that will be fully online going into next year in South America. With overall demand solid, operating rates will remain healthy although they may not be as high as recent levels.

The main issues to watch that could temper the strong pulp market include sluggish demand for major pulp consuming markets such as North American and European printing and writing papers and concern that the huge run up in pulp prices is pushing paper mills into bad financial shape. Every paper mill that closes is one less consumer of market pulp. In the big U.S. printing and writing paper market demand is off this year—North American demand for printing and writing papers is down 3.4% through September 2007 compared to last year. Overall world paper demand is moving ahead, buoyed by the continued and even accelerating growth in Asia.

Two other factors are also providing a push on pulp prices: higher energy costs and higher fiber costs. The surge in fiber costs is being caused by both short term disruptions and longer term supply issues and over the long term may support higher trend line pulp prices. This surge in paper and board demand in Asia is driving a huge appetite for both virgin pulp and recycled fiber, and pushing up prices. For example, in 2006 China's imports of wood pulp jumped 150% to 7.5 million tons. Prices on recycled fiber grades such as OCC are way up, driven by a 400% increase in imports in the last 6 years. In addition, fiber supplies are being limited by a number of structural factors as well as short term supply disruptions.

The heady level of pulp prices is likely to begin to place a ceiling on just how far prices can go. However, unless the U.S. economy slides into a recession as a result of the housing crisis, pulp mills in the US and other regions of the world are anticipating another good year next year. Healthy demand in combination with a weak US$ (particularly in Europe) and strong Canadian dollar should maintain momentum for producers and prop up pricing enough to counter the effect of low-cost Latin American capacity set to be brought online that will fully hit the market in 2008. Of course, what goes up does come down but it's anybody's guess when that will be. A third strong year in a row for market pulp is probably the safe bet to place for next year. ■

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