Hancock Natural Resource Group®

A Manulife Investment Management Company

Will the current resurgence in inflation bode well for timberland performance?

As the United States and other developed economies emerge from the COVID-19 pandemic, inflationary pressures have resurfaced accompanying the strong economic rebound. U.S. consumers have regained their confidence, leading to a resurgence in demand for goods and services. In the first quarter of 2021, U.S. GDP grew at an annual rate of 6.4%, and in June, the U.S. Federal Reserve (Fed) lifted its projection for U.S. GDP in 2021 to 7.0%.[1] Boosted by rates of economic growth that haven't been experienced since the early 1980s, inflation in the United States has also bounced back strongly and has been particularly prominent in explosive increases in the prices of lumber and wood panels. The circumstances of the current episode of inflation are unique—a global economic recovery from a major global pandemic—and the lack of clear historical points of comparison raises questions concerning the magnitude, duration, and implications for timberland of this particular outbreak of inflation. Will the past relationships between inflation and the return performance of timberland hold?

Over the past 40 years, timberland returns have been positively correlated with inflation, and timberland has generally fared well in periods of moderate to strong inflation. The only period where this positive correlation relationship lapsed, was in the post-global financial crisis (GFC) period of extremely low, sustained inflation (2008 to 2020). Our assessment of the timber market developments in the first half of 2021 suggest that the current rebound in inflationary pressures could actually be well aligned with past relationships between timberland returns and inflation and suggest possible improvements in return performance for U.S. timberland assets.

Chart 1: Timberland returns maintained a positive correlation with inflation in most periods when inflation has been moderate and strong

The correlation of U.S. timberland annual returns, U.S. inflation (CPI) 1961—2020

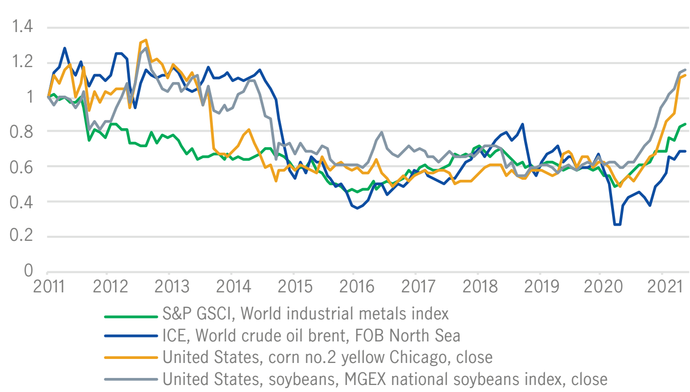
Source: Pre-1991 returns: John Hancock Timberland Index, NCREIF Timberland Index 1991 and later. Inflation from U.S. Bureau of Labor Statistics, April 2021. CPI refers to the Consumer Price Index.

Potential impacts of inflation on timberland returns—short term

Over the past year, a broad array of commodity prices has surged in response to the global recovery in economic activity, which has been particularly strong in the world's two leading economies, China and the United States. We've seen a recent surge in raw material prices across sectors, with strong gains across metals, energy, grains and oilseeds, and forest products. Forest products prices have been particularly volatile, outpacing the gains in other sectors. Between Q2 2020 and Q2 2021, the Random Length Framing Composite Index rose 222%, compared to a 113% increase in corn prices, a 60% increase in the S&P GSCI Industrial Metal Index, and 99% for Brent crude oil prices.

Chart 2: Post-COVID-19 commodity prices surge

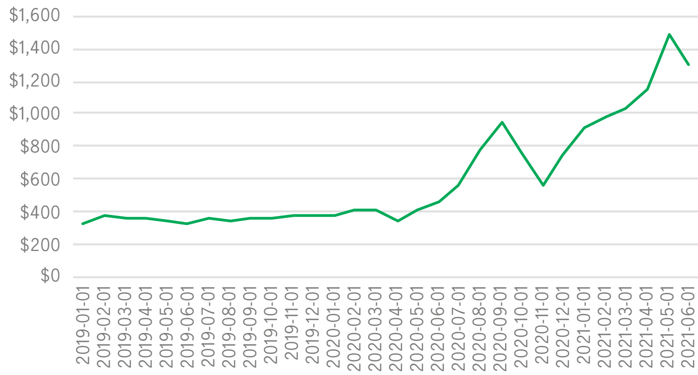
Oil, metals, agriculture prices: index 1/1/2011 = 1



Source: Macrobond, June 20, 2021, Freight on board (FOB), Goldman Sachs Commodity Index (GSCI), Minneapolis Grain Exchange (MGEX)

Chart 3: Post-COVID-19 lumber prices surge

Random Lengths Framing Composite, US$/MBF



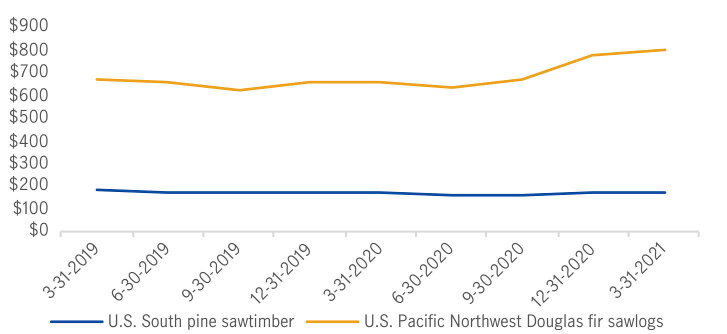
Source: Random Lengths, as of June 14, 2021. MBF = 1,000 board feet.

All these commodity prices were pushed higher by a combination of revived demand, restocking of supply chains, dislocations and constraints in shipping and delivery systems, and hoarding triggered by rising shortages and rising prices. Over the past year, forest products demand in the United States and other economies received a particularly strong boost to residential construction activity. The wide-spread lockdowns implemented to control the COVID-19 outbreak, the accelerated shift to working at home, and substantial government income support programs during the pandemic translated into both new home construction and repair and remodeling expenditures pushing up to cyclical highs in early 2021.

Most of the gains resulting from the explosion in forest product prices over the past year have been captured to date by the forest product companies, but timberland owners are also seeing positive impacts in 2021. The expanded profitability at lumber and wood panel mills has pushed mills to expand production, source more timber, and boost timber prices. The gains in timber prices are more moderate than for lumber and wood panels, and differ dramatically across different timber supply regions, but are expected to lead to increased revenue and cash returns for timberland investors.

Chart 4: U.S. timber price response varied across markets

Quarterly prices for southern pine sawtimber and Douglas fir sawlogs (US$/MBF)



Source: Fastmarkets RISI, as of May 5, 2021, TimberMart-South, Q1 2021

Potential impacts of inflation on timberland returns—medium term (two to three years)

Over the past month, softwood lumber prices have made a significant downward correction, and as of the week of June 24, the Random Lengths Framing Lumber Composite price had dropped 29% to US$1,190/MBF from the weekly high of US$1,675/MBF reached in the week of June 3.[2] A range of market dynamics have come into play in U.S. softwood lumber markets, including expanded production in the U.S. South, rising imports from eastern Canada and Europe, restocking of the supply chain, and a leveling off in demand. The stabilizing in U.S. demand reflects both the slower pace in new home construction and repair and remodeling activity. Builders of new homes are confronting shortages of materials and labor, while buyers are facing tight supplies and rising prices. Repair and remodeling demand has also cooled as consumers shift discretionary spending toward travel, entertainment, and dining away from home, as the economy becomes more open with the successful rollout of the U.S. vaccination program.

Despite the recent easing in the prices of lumber, metals, and other bellwether commodities, investors remain concerned that the rise in inflation could be more than a temporary blip, particularly for the United States. The commitment of the Fed to extend its accommodative monetary policy through this year and into at least 2022 combined with the Biden administration's push for outsize spending packages for infrastructure, expanded social programs, and climate change initiatives we believe are likely to fuel strong economic growth that could manifest itself in rising wage rates and general price inflation.

The June 24, 2021, Bloomberg survey shows that forecasters have raised their projections for inflation compared with their previous expectations (February 2021).[3] However, low unemployment, rising incomes, moderate interest rates, and appreciating home values are expected to be highly supportive of growth in demand for new homes and strong residential construction activity, the key macroeconomic driver of timberland returns.

Table 1: U.S. core consumer price inflation reaches 13-year high in June
Forecasts suggest higher inflation both short and medium term

	2021	2022	2023
June 2021 Bloomberg survey average*	3.5	2.5	2.3
February 2021 Bloomberg survey average*	2.2	2.2	2.2

*Based on 72 contributors of banks and financial institutions. Bloomberg as of June 24, 2021

Table 2: U.S. GDP expectations rise

	2021	2022	2023
June 2021 Bloomberg survey average*	6.6	4.1	2.4
February 2021 Bloomberg survey average*	4.8	3.7	2.5

*Based on 79 contributors of banks and financial institutions. Bloomberg as of June 24, 2021.

Potential impacts of inflation on timberland returns—longer term

If the current pickup in inflation was to continue to gain momentum, reenforced by the continuation of the Biden administration's accommodative fiscal and monetary policies, the potential would increase for a marked change in direction for U.S. monetary policy to bring inflation back to its target range around 2%. A move to higher interest rates and tightening credit availability could derail housing markets and precipitate an economic correction. The ability and speed at which markets will be able to rebalance following the COVID-19 pandemic is by no means clear. For example, reports in the media of wage inflation in manufacturing and the service sector are widespread, but in the United States, a lot of slack still exists in the labor market, and major adjustments could still occur as augmented unemployment compensation programs are phased out and the resumption of school programs address the lack of childcare options from holding back workers from returning to the labor force. It is noteworthy to point out that the recent run-up in inflation may be overstated in some of the year-over-year numbers that are reported in the press, since comparisons with Q1 2020 is measuring against a low base, reflecting the COVID-19 economic downturn.

However, the key driver of timber demand, residential construction activity (both new construction and repairs and remodeling of existing homes), should respond favorably to anticipated robust growth in the economy in the remainder of this year and we expect is likely extend into at least the first half of 2023. Timberland returns over the next few years should also benefit from the wave of investments that have been triggered by the unusually strong profitability experienced by the forest products industry. Forisk estimates that 1.4 billion board feet (BBF) of new North American softwood lumber capacity has been added over the past year, and that another 1.6 BBF will be coming in the second half of 2021.[4]

Endnotes

1. https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210616.pdf.
2. Fastmarkets RISI, as of June 28, 2021.
3. Bloomberg, as of June 24, 2021.
4. Forisk Market Bulletin, June 22, 2021.

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About Hancock Natural Resource Group

Hancock Natural Resource Group, Inc. is a registered investment adviser and part of Manulife Investment Management's Private Markets platform. We specialize in global farmland and timberland portfolio development and management on behalf of our investors worldwide. Our timber division manages approximately 6 million acres of timberland across the United States and in Canada, New Zealand, Australia, and Chile. Our agricultural investment group oversees approximately 300,000 acres of prime farmland in major agricultural regions of the United States and in Canada and Australia.

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Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than 150 years of financial stewardship to partner with clients across our institutional, retail, and retirement businesses globally. Our specialist approach to money management includes the highly differentiated strategies of our fixed-income, specialized equity, multi-asset solutions, and private markets teams—along with access to specialized, unaffiliated asset managers from around the world through our multimanager model.

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