

FOURTH QUARTER 2006 ECONOMICS CONDITIONS AND TIMBER MARKET REPORT

Economy

Economic growth has continued to moderate, consistent with our forecast over the last several quarters. Department of Commerce final real GDP for third quarter 2006 was revised down from 2.2% to 2.0%, versus 2.6% growth in the second quarter. The decline came primarily from a negative contribution from fixed residential investment, which was down sharply over the quarter from the unsustainable levels of the past few years. Continued strength in personal consumption expenditures, exports, non-residential investment and government spending combined to offset the decline in home building.

The Federal Reserve is maintaining a hawkish stance on inflation and left the Federal Funds rate unchanged during the quarter at 5.25%. Inflation also slowed, which is explained largely by declining energy prices. For the first eleven months of 2006 inflation ran at a 2.2% annualized pace, down from the 3.4% rate for 2005. Some observers believe the Fed will soon begin to lower rates, but lacking a financial shock that stops growth entirely or throws the economy into recession, we do not share this view. Even though economic growth has slowed, it is by no means stagnant, despite the decline in housing. Moreover, from a historical perspective, interest rates are not high. However, if inflation remains tame and growth slows significantly, the Fed could lower rates as much as 50 basis points by the end of 2007.

Our expectation is for economic growth to remain subdued at least for the first half of the year. Part of our view is based on the Treasury yield curve. At the end of fourth quarter the 2-year Treasury yielded 4.82%, versus 4.70% for the 10-year. Both were up slightly from second quarter figures of 4.71% and 4.64% for the 2- and 10-year. So although interest rates rose slightly, the yield curve remains inverted; what's more, it is now slightly more inverted than during third quarter.

Despite slower growth, the employment situation remains favorable, with the unemployment rate steady at 4.5% in December. However, the December non-farm payroll rose by a surprisingly robust 167,000 jobs versus 132,000 in November and 128,000 in October.

Mortgage rates declined to 6.24% in the fourth quarter, versus 6.40% in the third quarter and 6.33% year-to-year. Nonetheless, housing starts continued to drop from the previous year's record pace. November starts, at 1.506 million, were down 3% from October, and off 31.3% year-to-year. This is a substantial decline, and arguably if the trend continued unabated, it could lead to a recession or a no-growth economy.

But there are preliminary indications that housing may be finding a bottom. First, the 3% October-November decrease in housing starts was less than both the 5.2% monthly September-October decline and the 5.1% August-September drop. Second, sales of existing home actually rose slightly in November, up 0.6% from a month earlier. Finally, according to the National Association of Realtors, the national inventory of unsold homes was 7.3 months in November. While this was up from the year earlier figure of 5 months, it was down (very) slightly from 7.4 month figure reported in October. Clearly one month's worth of data does not constitute a trend. However, some of the imbalances that existed in an overheated housing market over the past several years may be starting to work through the system.

The ISM Index, an indicator of the strength of manufacturing activity, rose to 51.4% in December, up from 49.5% in November, but down from 52.9% in September. The ISM Index is a diffusion measure, with values above 50% indicating increasing growth in manufacturing and values below that figure implying contraction. The most recent figure means that manufacturing expanded slightly in December.

This is notable because the November value was the first in the last 41 months that the ISM Index dropped below 50. Again, a single observation does not constitute a trend, but the direction of and magnitude of change in the ISM Index over the next few months may be indicative of where the economy is headed. That the most recent value points to growth – albeit weak growth – is positive.

Forest Products Markets

Market pulp prices rose during the third quarter. Northern Bleached Softwood Kraft (NBSK) pulp prices are a bellwether of the strength of the pulp and paper sector. NBSK increased to \$730 at the end of December, versus \$711/ton in September, up 2.7% for the quarter and 18.7% year-to-year. Prices are now at their highest levels since the beginning of 2001.

Continued strength in the pulp market is partly due to the removal of excess capacity by the North American pulp and paper industry, especially in Canada. Producers in that country continue to deal with two major challenges: first, eastern Canada manufacturers in particular have among the world's highest cost structures, especially with respect to pulpwood prices. Second, although the Canadian dollar has weakened somewhat against the US dollar in the last few months, it remains at a historically high level.

Another factor that is bolstering pulp prices is continued strong pulp demand from China plus a weak U.S. dollar, which have combined to stimulate exports. U.S. pulp exports to China have more than tripled since 2000.

With respect to solid wood products, the slowing housing has led to ongoing weakness in lumber prices. That said, however, prices actually increased over the past month. The Random Lengths Lumber Composite was \$293 in December, up from \$275 in November (+6.5%) and almost equal to the \$292 September level. However, the December value is still down 20% year-to-year. Panel prices declined slightly with the Random Lengths Panel Composite at \$268 in December, down 2.5% from \$275 in November, and off 30% year-to-year.

Although down from year-ago levels, lumber and panel markets exhibited "relative" strength the last month or so for three reasons: first, housing starts currently are declining more slowly than was true a few months ago. Second, much of the US has experienced a much warmer than normal winter through the end of December, thereby extending the building season in those areas. Finally, there are reports that year-end production curtailments at US sawmills are more extensive than normal this year, which also has the effect of supporting prices.

Timber Markets

Timber prices are influenced by a variety of factors. These include macro- factors like final product markets for lumber, panels and paper, along with micro- factors like rainfall. Low rainfall increases timber availability because harvesting machinery is easier to operate when the woods are dry. All other things being equal, extended dry weather makes prices fall. High rainfall, in contrast, restricts harvesting to higher and drier areas, thereby raising prices. Sometimes very low (high) rainfall leads to price declines (increases) that can overwhelm otherwise positive (negative) market conditions.

Fourth quarter witnessed substantial variability in rainfall patterns throughout the South. Areas such as Virginia, North Carolina and Louisiana received normal seasonal rainfall, but places like Alabama and Georgia were drier than usual for this time of year. So while pine pulpwood prices increased an average of about 10% region wide, this "average" included declines of more than 15% in Alabama, as well as increases of over 30% in eastern North Carolina.

In some areas another factor – declining sawtimber prices – positively boosted pine pulpwood prices. Wood chips are a by-product of the lumber manufacturing process. A weak lumber market can positively influence pulpwood roundwood prices because as lumber production declines, a smaller volume of wood chips are produced to sell to pulp and paper mills. This happened in parts of Texas and Arkansas. Even though rainfall was somewhat below normal in those markets, pulp prices nonetheless realized some healthy gains. Sawtimber prices, in contrast, due to weakness in the housing market, dropped in these areas, leading to lower chip supplies, buoying pulpwood prices. On a Southwide basis, large pine sawtimber prices dropped 3.4%, while chip-and-saw prices declined about 1.2%.

In the Appalachian and Mid-South markets, hardwood sawtimber prices performed well overall, with average gains ranging from 2.3% in Tennessee, 3.3% in Kentucky and 3.7% in Ohio. But again, wide variations existed not only in the different markets, but also across species. For example, across the three states, red oak prices dropped an average of 6.4%, while white oak rose 5.0% and hard maple increased 2.9%.

The US seems to be in store for a less than robust economy, probably at least for the next few quarters. Housing will probably continue to be a major player in the scenario that ultimately unfolds. Although pine sawtimber is seeing price declines in response to housing, some of this is currently being offset by greater strength in pulpwood and hardwood sawtimber. This lack of correlation in different timber markets and products is a key reason that RMK has for many years advocated to clients a portfolio-driven approach to timberland investing.