

FOURTH QUARTER 2007 ECONOMIC CONDITIONS AND TIMBER MARKET REPORT

Economy

Economic growth rose in the third quarter, with the final Department of Commerce GDP figure at 4.9%. This was ahead of the 3.8% second quarter number. The increase reflected positive contributions from exports, personal consumption expenditures (PCE), private inventory investment, nonresidential construction, federal, state and local government spending. These increases were partially offset by negative contributions from residential fixed investments and imports (imports are a subtraction from GDP). For the twelve-month period ending in the third quarter, GDP rose at a 2.8% annual rate. Despite third quarter's increase we believe growth will weaken substantially going into 2008, possibly putting the economy into recession.

Retail sales are slowing as consumers worry about weakness in housing and slower job growth. The US Census Bureau reports that December retail sales declined 0.4% from November, and were up 4.1% year-to-year. However, the National Retail Federation, the world's largest retail trade organization, projects that 2008 retail sales will rise only 3.5%; this would represent the slowest rate since 2002 when retail sales rose 3.0%.

After "blinking" in third quarter by cutting the Federal Funds Rate to 4.75%, the Fed cut again on October 31st to 4.5%, then again to 4.25% on December 11th. During the same period, the Fed dropped the Discount Rate from 5.25% to 4.75%. A year earlier the Fed Funds Rate and Discount Rate respectively stood at 5.25% and 6.25%. On January 10th, Fed Chairman Bernanke gave a speech in which he indicated that additional, possibly aggressive, rate cuts are a strong possibility. A 50 basis point cut at the Fed's January meeting is extremely likely, and some forecasters believe it will be higher. Mr. Bernanke's recent pronouncements and this aggressive loosening publicly acknowledges that the Fed thinks the country is on weak economic ground.

As mentioned last quarter, we are concerned that continued rate cuts will exacerbate inflation. In January the price of gold, a widely regarded indicator of future inflation broke through the \$900/ounce barrier, an all-time record in nominal terms. The price of crude oil hit \$100/barrel at the beginning of the new year, also a record, although it has since retreated somewhat. Finally, the dollar continues to trade in a range near its historical lows against the Euro. By itself the weak dollar raises inflation risks because it makes imports – like oil – more expensive.

Our inflation concerns expressed in earlier reports are being borne out. December inflation rose 0.3% from a month earlier, following a November reading of 0.8%. For the entire year, inflation jumped 4.1% from 2006. In 2006, the CPI increased 2.1%. The 2007 CPI increase was the fastest since 1991, when it rose 5.65%.

Much of the rise in the CPI is from sharp increases in energy prices, which rose 17.4% in 2007. Other contributors were food and medical care costs, which climbed 4.9% and 5.2% respectively. Clearly, inflation is at a worrisome pace. To put this into perspective, the long-term average annual historical increase in the CPI is about 3.5%. Going forward, energy and food prices will likely continue to contribute to above-average inflation. With the Fed's recent stated willingness to cut rates further, a weakening dollar and more expensive imports should continue fueling this rise.

Treasuries declined during the quarter across most maturities, consistent with a slowing economy. At quarter end, the 2-year Treasury yielded 3.12% versus 4.01% in third quarter. The 5-year went to 3.49%

versus 4.20% a quarter earlier, and the 10-year Treasury was 4.10% versus 4.52%. The 1-month dropped to 2.86% from 3.78%, at the end of third quarter. The positively sloped yield curve suggests credit markets anticipate positive, but weakening economic growth going forward.

The unemployment rate jumped 0.3% over the quarter, to 5.0%. This compares to 4.7% in third quarter and 4.5% in second quarter. Unemployment is now at its highest level since 2005. Fourth quarter non-farm payroll figure was 138,143 jobs, down from 138,162 the prior period.

The 30-year mortgage rate declined in fourth quarter to 6.10% versus 6.38% a quarter ago. Today's rate essentially equals the 6.14% rate that prevailed a year ago. The decline during the quarter is indicative of the sharp drop in demand, continued problems in US credit markets and tighter lending standards.

Housing starts fell 14.2% in December to an annual seasonally adjusted rate of 1.006 million units, a dramatic drop. For the entire year starts fell 24.8%. In percentage terms, the 2007 decline is the worst since 1980, when starts fell 26%. Those old enough to remember, however, will recognize one big difference between these two points in time: in 1980, a 30-year mortgage rate was 12.7%, more than twice its current level.

Existing home sales in November (most recent data available) did better, and up 0.4% from a month earlier, but still off 20% year-to-year. New single-family home sales fell 9% in November from the prior month, and fell 45.4% from a year earlier. The current situation continues to confirm our view that housing, particularly new home sales will get worse before getting better. Nationwide, unsold home inventories, are at 9.3 months, an 18-year high. We expect housing in markets like California and Florida to suffer continued weakness until at least 2009.

The ISM Index, an indicator of the strength of manufacturing activity, had an unexpectedly sharp decline to 47.7% in December, versus 50.8% in November and 51.4% a year earlier. This is consistent with a slowdown in manufacturing. The ISM is a diffusion measure, with values above 50% indicating growth in manufacturing and values below that level signaling contraction. The December reading means manufacturing, which previously was slowing, is now contracting. This not only supports an economic slowdown scenario, but if it is sustained over the next several months is further evidence of a possible recession unfolding.

Forest Products Markets

Market pulp prices rose during third quarter. The price of Northern Bleached Softwood Kraft (NBSK) pulp is a bellwether for the pulp and paper sector. NBSK rose to \$875 at the beginning of January, versus \$826 at the end of September, a 5.9% rise for the quarter and a 40% increase year-to-year. Prices are today at historical highs, well ahead of the previous record of \$710/ton that was in 2000.

Given that we see the US economy is slowing, record high pulp prices may seem counter-intuitive, but this situation has arisen from several reinforcing events. First, industry consolidation and rationalization of North American and European pulping capacity from the late 1990s to the early 2000s reduced supply. This was followed by the economic recovery in the wake of the 2001 recession, which took place alongside extremely rapid GDP growth in emerging economies like China. In each case these led to rapid growth in the demand for pulp. When this was combined with reduced capacity, it meant producers could not rebuild pulp inventories, which remain at low levels even now. Finally, a weak dollar has put the US in an excellent export position – through November, US pulp exports to China rose 15% from a year earlier.

We expect pulp prices to remain in reasonable shape for the next one or two quarters due to continued weakness in the dollar and strong overseas demand. But price increases then may slow or flatten because paper demand (for which pulp is the major input) is expected to soften, at least in the US. Paper demand historically is linked to housing permits and the ISM New Order Diffusion Index (a sub-component of the ISM Manufacturing Index). Housing permits have now declined for six straight months and the New Order Diffusion Index recently went below 50%. This suggests paper markets will begin exhibiting weakness over the next few months, which ultimately should moderate pulp prices. That said, it is also possible that the strong Canadian dollar along with high production costs in that country, which have resulted in ongoing Canadian mill closures, could offset at least some downward pressure on paper in the US market.

The US the housing market is already in a recession, and in some areas is in what is better described as a depression, particularly places like Florida and California. Housing woes have caused lumber and panel prices to slump. The Random Lengths Lumber Composite fell to \$262 in early January, versus \$276 in September, a 5.1% drop. The index is down 9% over the past twelve months and now at its lowest monthly level since it was first introduced over a decade ago. The average of the Index for the twelve months of 2007 was \$283, the lowest on record. In 2007 the Index was 13% lower than the second lowest year, which was 2006, when the Index stood at \$327.

The drop in home sales through December suggests that housing has not yet bottomed. We therefore expect continued softness in lumber prices. For the year, lumber production fell 13% in the US South, 27% on the West Coast and 25% in the Inland West.

Panel prices also dropped during the quarter. The Random Lengths Panel Composite fell to \$288 in early January from \$296 in September, down 2.7%. However, the Index is actually up 5.5% year-to-year. This relative strength in panel markets is due to a supply/demand imbalance for plywood. The Random Lengths Panel Composite includes both plywood and oriented strand board. OSB prices remained flat for the last year and are down sharply for the last two years, because the fortunes of OSB are closely linked to housing. Plywood, in contrast is employed in a variety of alternative uses. Plywood prices have stayed relatively strong because plywood imports to the US haven fallen 98% year-to-year (through September, the most recent data available). This decline is due to the weak dollar. At the same time US plywood manufacturing capacity is in long-term decline as it is replaced by OSB. Therefore, US manufacturers are largely unable to offset the supply decline by increasing domestic production.

Timber Markets

Macroeconomic factors like housing directly influence lumber and panel price, and by extension the price of timber. But microeconomic drivers, which can be as diverse as rainfall and local mill openings or closures also drive timber prices within individual timber markets. Weak lumber prices have to some extent resulted in flat softwood sawtimber pricing in some markets. However, major differences in rainfall patterns throughout the US South during 2007 resulted in a high degree of market-to-market variability. The eastern part of the South is extremely dry – parts of Alabama and Georgia have experienced the most severe drought on record. In contrast, the western southern sub-region has seen rainfall levels that are far above normal.

Southwide, large pine sawtimber prices were flat during the quarter, with a 0.02% decline. On an annual basis prices were all but unchanged as well, marking a 0.02% increase. Chip-and-saw, utilized to make 2x4s and therefore directly impacted by housing, fell 0.5% for the quarter, but 7.5% for the year. As is

almost always true, this region-wide average includes substantial variability on a state-to-state basis. For example, chip-and-saw prices declined 7% in northern Florida, but were up 9% in northeast Texas.

Pine pulpwood fared better region-wide, with an average increase of 0.8%. Ongoing strength in pulp markets has resulted in steady continued demand for pulpwood. Areas with above-normal rainfall fared better than the regional average. But again, large local differences exist, with prices in southeast Texas up 7%, but with markets witnessing a 5% drop in eastern North Carolina.

Throughout the South, a microeconomic factor that influences pulpwood is that a weak lumber market leads to lower woodchip availability for pulp and paper mills. Wood chips are a by-product of lumber manufacture, so when lumber markets perform poorly pulpwood supplies must be augmented from roundwood. This increases the price of roundwood pulpwood. Similar variability in pricing existed for hardwood pulpwood. Hardwood pulpwood prices declined 3.7% over the quarter, but were up 15.8% year-to-year.

In the Appalachian and Mid-South markets, hardwood sawtimber prices were flat to down. This is normal during a period of weak housing, because hardwood prices track housing with a lag. A weak housing environment means that sales of hardwood products as furniture, flooring and cabinets decline. Red oak prices fell 4% and 6% in Tennessee and Kentucky, respectively, but were flat in Ohio. Hard maple prices fell 2.5% to 7% in Tennessee and Kentucky and 6% in Ohio. Hard maple was down by a similar magnitude in the same states. In contrast, hardwood pulpwood was up 10% in southern Tennessee, but flat in Kentucky and Ohio.

We believe the US is geared for slowing growth over the next nine to twelve months, pulled down by housing along with the weak financial sector. Over the rest of the year we expect softwood sawtimber prices to be flat, absent a seasonal rise in the spring as the building season – albeit a weak one – begins. If normal rainfall return to the eastern half of the South over the remainder of the winter, pulpwood prices may see a significant bump from current levels.

We continue to be concerned about the rapidity and magnitude of the Fed's accommodative stance on interest rates, which is likely to increase future inflationary pressures. Over the last quarter we have witnessed record prices for both oil and gold, continued weakness in the world value of the dollar and uncomfortably high inflation. This has heightened the risk of recession in 2008. Having said that, during inflationary periods, "hard" assets like timberland historically tend to outperform financial assets. Moreover, timber value increases primarily from regular periodic biological growth, which is completely uncorrelated to conditions in financial markets.