

Department of Natural Resources
Economic & Revenue Forecast

Fiscal Year 2019, Third Quarter
February 2019



Forecast Summary

Lumber and Log Prices. Lumber prices in 2017 increased through the year from \$350/mbf to \$490/mbf, averaging \$425/mbf for the year—significantly higher than previous years and the highest prices in real terms since the height of the previous housing boom in 2005. Prices continued to increase through the first half of 2018, averaging \$569/mbf through July, peaking at \$635 before dropping markedly to \$324/mbf in November. However, since then prices have increased to \$340 in December, suggesting that November may have been the nadir.

Prices for the ‘typical’ DNR log were also markedly higher in 2017 than previous years, climbing from \$578/mbf in January to \$719/mbf in December, averaging \$611/mbf for the year. Prices for DNR logs increased in the first quarter of 2018, averaging \$722/mbf, before falling slightly in the second quarter to average \$706/mbf. Prices have fallen markedly since peaking at \$700/mbf in July, to \$519/mbf in December. Unlike lumber prices, it appears that the bottom was not reached in November.

Log and lumber prices were expected to weaken in the final two quarters of 2018, but they were still expected to stay above recent years’ averages, before climbing back to near early-2018 levels in early 2019. That is, obviously, no longer the case. The steepness of the price decline was surprising and appears to be due to a confluence of a number of factors that undermined upward pressure. As discussed in the main forecast, throughout the latter half of 2018 housing starts stalled, house prices growth flattened (and declined in some areas, like Seattle) and lumber mills built significant inventories of both logs and lumber. The updated forecast for prices, suggests that prices will recover from their current lows in 2019, and will average something close to 2017 prices. Prices are expected to continue increasing through mid-2021, though they are not expected to approach the highs seen in 2018.

Timber Sales Volume. FY18 sales volume ended at 496 mmbf, slightly above the June forecast. Sales

plans in the current and outlying years have not changed, so absent a new sustainable harvest calculation, sales volume forecasts remain at 500 mmbf. Unfortunately, with the drop in timber and lumber prices and the weak demand, a number of DNR’s recent contracts have been passed over at auction with no bidders. It is DNR’s intention to bring more than 500 mmbf to auction in FY 19, however, given the number of contracts with no bidders, 500 mmbf was determined to be a reasonable estimate of what will actually sell.

Timber Sales Prices. Auction prices for FY18 totaled \$458/mbf, well above the FY17 average of \$346/mbf. The sales price forecast for FY19 was increased to \$370/mbf in the September forecast, due to the strong prices in the first half of 2018 that were forecast to wane, but not collapse. This was pulled back to \$360 in November, which was still achievable given the sales to-date available for the November forecast. Given the weakness in sales to-date, the stumpage price is further reduced in this forecast to \$350. The sales price forecasts for outlying years are unchanged at \$340/mbf despite expectations for increases in log prices. This is because there are a number of risks to house prices and the broader economy that could adversely affect log and stumpage prices.

Timber Removal Volume and Prices. Harvest volume forecast are altered significantly. Timber removals for FY19 are reduced by 30 mmbf to 520 mmbf because harvests to-date have been much lower than expected. It is still possible that harvests will rebound, harvests in the first six months of FY18 looked very similar to what we’ve seen in FY19, but then picked up markedly in the latter six months. However, the market situation is expected to be much different this year, with prices increasing much more slowly and much weaker housing starts.

The volume not harvested in FY19 is essentially pushed out to outlying years.

Timber removal prices for FY19 are decreased to \$373/mbf, due in part to the decreased price expectations as well as an increased proportion of the harvest to-date being lower priced timber. Prices in outlying years are not meaningfully changed.

These removal prices reflect changes in both the sales prices and removal timing.

Timber Revenue. The changes to the timber harvest volume has significantly reduced projected revenue in FY19, decreasing it by \$15 million to \$194 million. While this is a large change from the previous forecast, it is largely in line with previous years, and actually around \$16 million more than was collected in FY18.

Revenues for the 2017-2019 biennium are forecast to total \$372 million, a decrease of 3.9 percent (\$15 million) from November's forecast. Forecast revenues for the 2019-2021 biennium are increased by 0.1 percent (less than \$1 million) to \$397 million.

Non-Timber Revenues. In addition to revenue from timber removals on state-managed lands, DNR also generates sizable revenues from managing leases on uplands and aquatic lands.

The non-timber uplands revenue forecast for FY19 is increased by \$1 million due to higher than expected revenues in irrigated agriculture, and orchards and vineyards. These increases have offset a small decrease in commercial leases due to maintenance costs. Non-timber uplands sources in all other years are unchanged.

Aquatic lease revenues in FY19 are increased slightly, with a better outlook in water- and non-water-dependent leases outweighing a small decrease in other aquatic leases. Outlying years are increased due to increased expectations for non-water-dependent leases.

FY19 geoduck revenue is decreased in all years due to an update price forecast reflecting recent price weakness. This price weakness appears to be due largely to the tariff's China implemented in mid-2018 and may disappear if the tariffs are lifted.

Total Revenues. Total revenues for the 2017-2019 Biennium (FYs 18-19) are decreased by 4.1 percent (\$23 million) to \$526 million. Revenues for the 2019-2021 Biennium (FYs 20 and 21) are essentially unchanged at \$539 million.

Notes to the Forecast. There are a number of

sources of significant uncertainty for DNR revenue and the overall economic activity. These include DNR specific issues, such as the as-yet undetermined sustainable harvest volume, as well as broader economic issues including the trade difficulties with China, a slowdown in Chinese economic growth, a recent slowdown in the housing market and significant political uncertainty surrounding the U.S. Federal Government.

While the sales volume estimates are based on the best available internal planning data, they are subject to adjustments due to ongoing operational and policy issues. In particular, these issues are likely to affect sales volumes in outlying years, where the assumed sustainable harvest volume of 500 mmbf might be too high.

The most concerning factor in this forecast, and likely for forecasts in the near future, is the combined problem of the slowdown in housing construction and the decreasing exports to China.

Chinese imports of U.S. logs and lumber started in meaningfully amounts in 2010 and provided support to prices in the worst years following the Recession in 2008-09, when housing construction was very low. However, Chinese imports have dropped dramatically since 2014. While Chinese demand has been dropping, domestic housing demand has been picking up speed and seems to have more than offset the decrease in China-bound exports. Indeed, it appears that the strong log and lumber price growth from 2017 and the beginning of 2018 was due largely to housing construction, but that housing construction growth has stalled.

In August, China proposed another round of tariffs in response to new U.S. tariffs. Currently these proposed tariffs include hardwood logs and products and some softwood products, though not softwood logs. These tariffs will likely undermine the domestic price of logs and will put pressure on processing industries. These are on top of tariffs announced in June 2018 on U.S. goods that included both agricultural products and geoducks, both of which are significant DNR-managed asset classes. Although it is not yet clear that these tariffs have affected timber revenues, though it is likely, it does appear that

the tariffs have affected geoduck prices and therefore revenues.

China is still a major market for Washington timber and lumber and the demand drop represents a continuing downside risk for the forecast. Aside from the trade tensions discussed above, there are other things that could undermine Chinese demand, such as a further slowdown in Chinese economic growth or continued loss of PNW market share to international and Southeastern US competitors.

Continued growth in domestic housing demand was expected to offset the continued decline in China-bound exports. If housing construction does not resume its growth, as optimistic analysts have forecast, and Chinese exports continuing to decline, then log and lumber prices will not recover and could continue to fall, in which case even our conservative current stumpage forecast may be optimistic.

A potentially major concern for the overall U.S. economy, which would affect DNR revenue, is the continued political uncertainty surrounding the U.S. Federal Government. The government was recently shutdown from December 22, 2018 to January 25, 2019 and was the second federal government shutdown of the current U.S. administration. Although the shutdown itself is likely to only meaningfully negatively affect GDP growth in the first quarter of 2019, it is a presage to more uncertainty. Particularly because the deal to open the government only lasts until February 15 and the U.S. administration has expressed a willingness to shutdown the government again if the two leading parties are not able to come to a budget agreement.

The Congressional Budget Office estimated that the cost of the shutdown was around \$11 billion in lost GDP revenue, all but \$3 billion of which will likely be recovered. That is an insignificant amount compared to the overall size of the U.S. economy. However, if the government were to shut down again, the impacts are likely to be non-linear, that is, they may be small while a shutdown is short, but may grow substantially as it progresses or it is repeated.

During the shutdown there were reports of businesses facing delays in getting license approval, decisions about regulations, import licenses or approval for new products. These delays were cleared up quickly after the shutdown ended, but the losses and uncertainty that the shutdowns cause could grow dramatically if they start affecting businesses cash flows.

The direct impact of the shutdown on DNR will mostly come from the affect on the housing market, potentially delaying the expected recovery in the first quarter of 2019. Single-family home loans through the FHA and all types of VA loans were still funded through the shutdown, though potentially with delays, while some other types of FHA loans were not processed. Most conventional mortgages are not backed by the federal government and were processed as usual, though tax transcript processing at the IRS was disturbed and caused delays in application processing.

To be clear, in the end, the effects of the Federal Government shutdown were likely minimal and were likely insignificant compared to the size of the economy. However, shutdowns cause meaningful instability in an economy and could have significant unforeseen impacts if they happen too often.

An additional negative impact of the shutdown is that it has delayed release of important economic data. For instance, data on new houses sold and months supply of housing was only recently updated to November. This delay in economic data makes it more difficult to get a grasp of whether the apparent weakness in the housing market was a seasonal blip or something that is becoming a stronger trend.

If the current malaise of the housing market is only temporary, a meaningful recovery in construction would offer some up-side potential to this forecast. Unfortunately, there are a number of significant impediments, on both the supply and demand sides, to a strong recovery in prices and starts. Constraints on demand include persistently stringent lending standards, a continued tough labor market for younger workers, enormous student loan debt, poor wage growth, and now increasing interest rates. It has been surprising how high prices have

risen given these constraints. Additional, supply side impediments constraining construction growth include a lack of skilled labor or readily buildable land.

Since the expiration of the Softwood Lumber Agreement (SLA) in late 2015, the U.S. and Canada have been without a trade agreement that covers lumber. As of late 2017 a U.S. ITC finding cleared the Department of Commerce to impose duties, which have been set at 20.23%. Although Canada has appealed the finding to a NAFTA panel and has filed a complaint with the WTO, much of the short-term uncertainty about trade costs is gone. Without a breakthrough on the new SLA negotiations or a finding from the WTO or NAFTA panel, the markets are unlikely to see the price volatility that the previous duty uncertainty caused. Additionally, at current lumber prices, the duties shouldn't be significant enough to reduce Canadian production.

Aside from the tariffs pushing down geoduck prices, which they appear to have done, China has twice instituted bans on Pacific Northwest shellfish on food safety grounds—paralytic shellfish poison (PSP) and arsenic contamination. It's not clear that either of these bans significantly affected prices or harvest activity. However, it is entirely possible that China could re-enact a more forceful ban on geoduck that would have a dramatic effect on geoduck prices, and therefore revenue.

As always in the geoduck fisheries, PSP closures create uncertainty around harvest volumes as well.

Table 1: February 2019 Forecast by Source (millions of dollars)

Timber Sales		FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23
Volume (mmbf)		545	520	496	500	500	500	500	500
	Change				-	-	-	-	-
	% Change				0%	0%	0%	0%	0%
Price (\$/mbf)		285	346	458	350	340	340	340	340
	Change				\$ (10)	\$ -	\$ 0	\$ 0	\$ 0
	% Change				-3%	0%	0%	0%	0%
Value of Timber Sales		155.3	179.8	227.1	175.0	170.0	170.1	170.1	170.1
	Change				\$ (5.0)	\$ -	\$ 0.0	\$ 0.0	\$ 0.0
	% Change				-3%	0%	0%	0%	0%
Timber Removals									
Volume (mmbf)		490	493	528	520	554	564	535	529
	Change				(30)	0	5	6	19
	% Change				-5%	0%	1%	1%	4%
Price (\$/mbf)		338	313	338	373	362	348	341	343
	Change				(6.8)	(0.5)	(1.6)	(1.2)	1.9
	% Change				-2%	0%	0%	0%	1%
Timber Revenue		165.7	154.2	178.6	194.0	200.5	196.2	182.4	181.7
	Change				(15.0)	(0.2)	0.7	1.4	7.4
	% Change				-7%	0%	0%	1%	4%
Upland Leases									
Irrigated Agriculture		8.7	9.1	10.4	9.5	9.0	9.0	9.0	9.0
	Change				0.5	-	-	-	-
	% Change				6%	0%	0%	0%	0%
Orchard/Vineyard		8.2	8.1	8.5	8.9	8.2	8.2	8.2	8.2
	Change				0.7	-	-	-	-
	% Change				9%	0%	0%	0%	0%
Dryland Ag/Grazing		5.2	5.6	6.6	5.8	6.0	6.0	6.0	6.0
	Change				-	-	-	-	-
	% Change				0%	0%	0%	0%	0%
Commercial		9.0	9.7	10.9	10.2	10.4	10.4	10.4	10.4
	Change				(0.2)	-	-	-	-
	% Change				-2%	0%	0%	0%	0%
Other Leases		10.5	10.7	10.3	9.8	10.1	10.2	10.2	10.2
	Change				-	-	-	-	-
	% Change				0%	0%	0%	0%	0%
Total Upland Leases		41.6	43.1	46.7	44.2	43.7	43.8	43.8	43.8
	Change				1.0	-	-	-	-
	% Change				2%	0%	0%	0%	0%
Aquatic Lands									
Aquatic Leases		11.1	10.8	12.0	12.0	10.7	10.6	10.6	10.6
	Change				0.6	0.2	0.2	0.2	0.2
	% Change				5%	2%	2%	2%	2%
Geoduck		14.5	27.9	26.4	21.1	17.3	17.6	18.0	18.9
	Change				0.2	-	-	-	-
	% Change				1%	0%	0%	0%	0%
Aquatic Lands Revenue		25.6	38.7	38.4	33.1	27.9	28.2	28.6	29.5
	Change				0.7	0.2	0.2	0.2	0.2
	% Change				2%	1%	1%	1%	1%
Total All Sources									
		232.9	236.1	263.7	271.2	272.0	268.1	254.8	254.9
	Change				(13.3)	0.0	0.9	1.6	7.6
	% Change				-5%	0%	0%	1%	3%

Table 2: February 2019 Forecast by Fund (millions of dollars)

Key DNR Operating Funds		FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23
041	RMCA - Uplands	36.0	33.7	40.6	39.2	40.9	41.5	40.0	39.7
	Change				(2.3)	(1.0)	(0.1)	0.2	0.9
	% Change				-5%	-2%	0%	0%	2%
041	RMCA - Aquatic Lands	11.3	17.9	17.6	14.7	12.4	12.5	12.7	13.1
	Change				0.3	0.1	0.1	0.1	0.1
	% Change				2%	1%	1%	1%	1%
014	FDA	22.8	22.0	22.1	25.6	26.4	24.8	22.5	22.6
	Change				(1.9)	1.0	0.4	0.1	1.0
	% Change				-7%	4%	1%	0%	5%
21Q	Forest Health Revolving			4.4	7.5	8.6	10.4	10.7	10.2
	Change				0.6	(1.6)	(0.4)	0.6	0.4
	% Change				8%	-15%	-3%	6%	5%
Total DNR Key Operating Funds		70.2	73.6	84.7	87.0	88.2	89.1	85.9	85.7
	Change				(3.3)	(1.5)	(0.1)	1.0	2.4
	% Change				-4%	-2%	0%	1%	3%
Current Funds									
113	Common School Construction	59.7	51.8	62.6	65.5	67.9	68.2	65.8	65.4
	Change				(4.3)	(1.2)	(0.2)	0.2	1.4
	% Change				-6%	-2%	0%	0%	2%
999	Forest Board Counties	55.3	58.5	59.6	67.0	65.4	60.9	55.3	55.6
	Change				(4.0)	2.5	0.9	0.2	2.6
	% Change				-6%	4%	1%	0%	5%
001	General Fund	4.1	2.6	2.1	2.8	4.1	3.9	3.6	3.6
	Change				(0.5)	0.2	0.1	0.0	0.2
	% Change				-15%	5%	2%	1%	5%
348	University Bond Retirement	1.8	1.8	3.2	1.5	1.7	1.9	1.9	1.8
	Change				(0.3)	(0.1)	(0.0)	0.0	0.0
	% Change				-17%	-7%	-1%	1%	2%
347	WSU Bond Retirement	1.4	1.7	1.6	1.7	1.7	1.7	1.7	1.7
	Change				0.1	-	-	-	-
	% Change				3%	0%	0%	0%	0%
042	CEP&RI	3.1	4.1	5.3	2.4	3.6	4.1	4.1	4.0
	Change				0.1	(0.1)	0.0	0.1	0.1
	% Change				5%	-3%	1%	1%	2%
036	Capitol Building Construction	6.7	8.2	6.2	7.9	8.4	8.4	7.9	7.9
	Change				(0.8)	(0.2)	(0.0)	0.0	0.3
	% Change				-9%	-3%	0%	1%	3%
061/3/5/6	Normal (CWU, EWU, WWU, TESC) School	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2
	Change				0.0	-	-	-	-
	% Change				3%	0%	0%	0%	0%
Other Funds		0.1	0.0	1.1	1.3	0.9	0.4	0.2	0.3
	Change				(0.3)	0.2	0.0	(0.0)	0.1
	% Change				-19%	28%	4%	-15%	40%
Total Current Funds		132.2	129.0	141.7	150.4	153.9	149.8	140.6	140.5
	Change				(10.0)	1.2	0.8	0.5	4.5
	% Change				-6%	1%	1%	0%	3%

(Continued)

Table 3: February 2019 Forecast by Fund (millions of dollars), cont'd

Aquatic Lands Enhancement Account		FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23
02R		14.2	20.8	20.8	18.3	15.6	15.7	15.9	16.3
	Change				0.4	0.1	0.1	0.1	0.1
	% Change				2%	1%	1%	1%	1%
Permanent Funds									
	601 Agricultural College Permanent	7.6	4.6	4.2	6.4	5.7	4.7	3.9	4.1
	Change				(0.5)	0.5	0.1	(0.0)	0.3
	% Change				-7%	10%	3%	-1%	7%
	604 Normal School Permanent	2.4	3.1	4.1	3.2	3.2	3.0	2.7	2.8
	Change				(0.1)	(0.1)	(0.0)	(0.0)	0.1
	% Change				-2%	-2%	-1%	0%	4%
	605 Common School Permanent	1.0	0.6	0.8	0.3	0.3	0.3	0.3	0.3
	Change				-	-	-	-	-
	% Change				0%	0%	0%	0%	0%
	606 Scientific Permanent	5.0	4.1	7.0	4.9	4.6	5.0	4.9	4.8
	Change				0.2	(0.3)	(0.0)	0.0	0.1
	% Change				5%	-5%	0%	1%	3%
	607 University Permanent	0.2	0.3	0.3	0.5	0.6	0.6	0.5	0.5
	Change				(0.0)	(0.0)	(0.0)	0.0	0.0
	% Change				-7%	-7%	-3%	0%	3%
Total Permanent Funds		16.2	12.6	16.5	15.4	14.4	13.6	12.4	12.4
	Change				(0.4)	0.2	0.0	0.0	0.5
	% Change				-2%	1%	0%	0%	4%
Total All Funds									
		FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23
		232.9	236.1	263.7	271.2	272.0	268.1	254.8	254.9
	Change				(13.3)	0.0	0.9	1.6	7.6
	% Change				-5%	0%	0%	1%	3%

Figure 1: Timber Forecast Charts

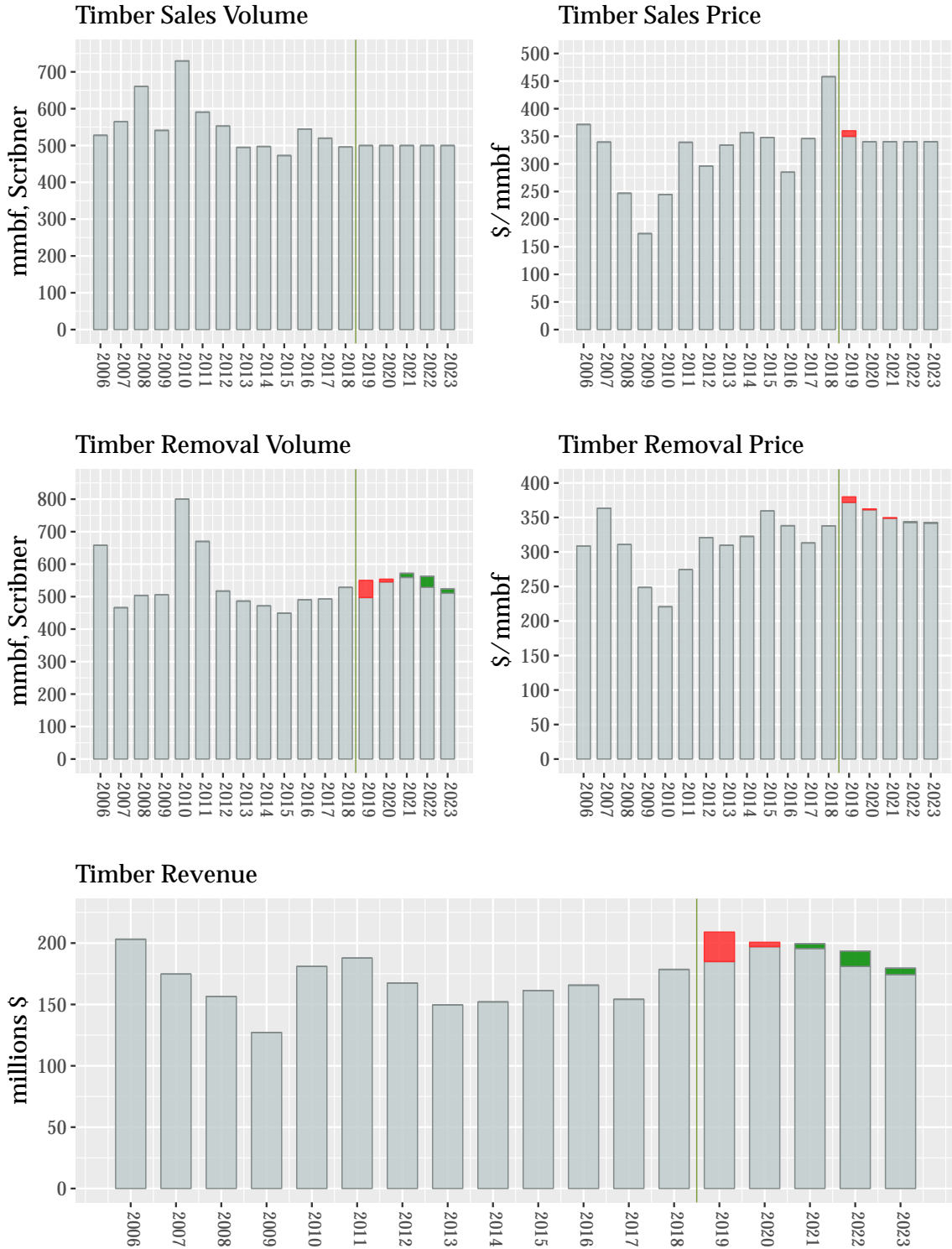


Figure 2: Other Uplands Forecast Charts

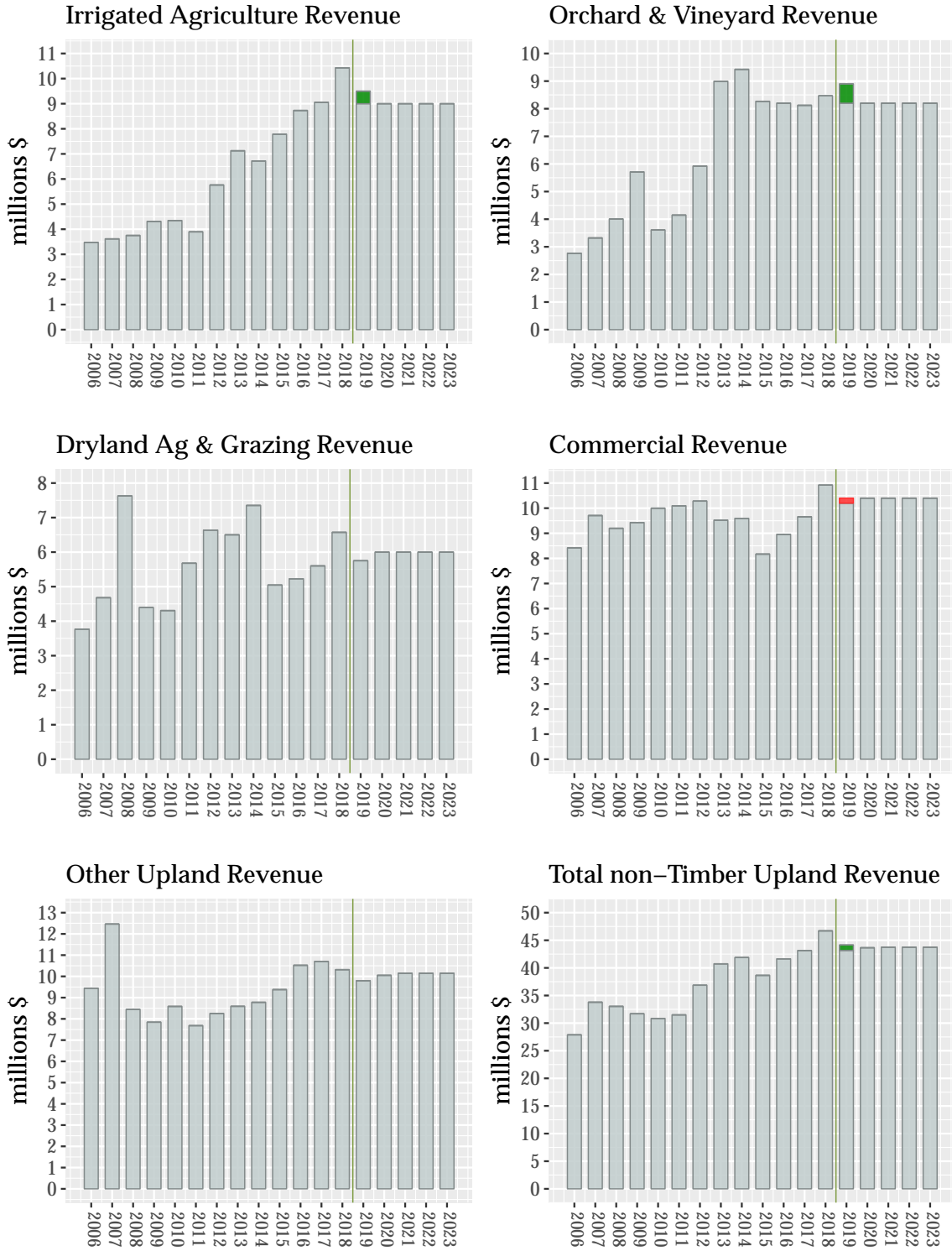
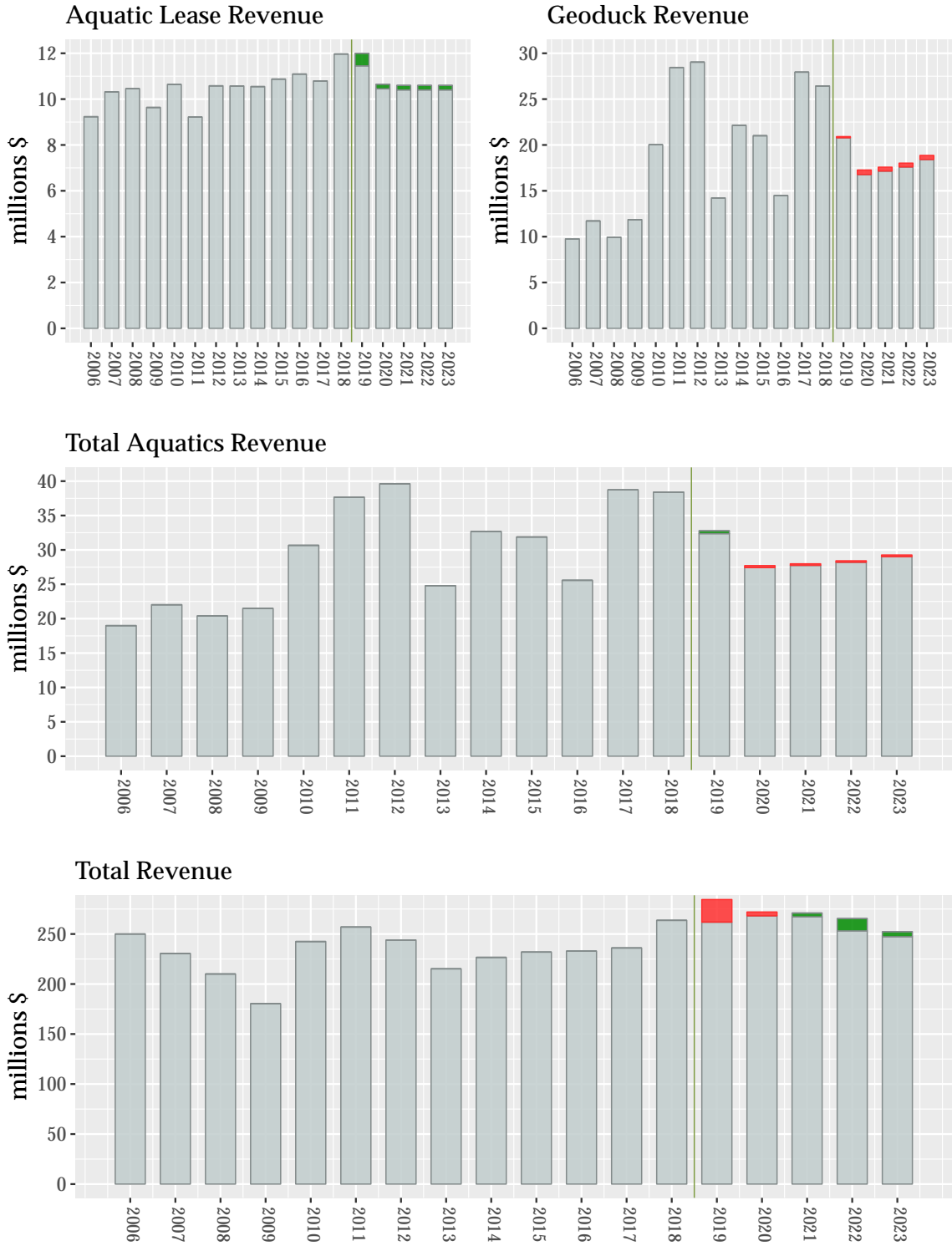


Figure 3: Aquatics and Total Forecast Charts



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Acronyms and Abbreviations

bbf	Billion board feet
BLS	U.S. Bureau of Labor Statistics
CAD	Canadian dollar
CNY	Chinese yuan (renminbi)
CPI	Consumer Price Index
CY	Calendar Year
DNR	Washington Department of Natural Resources
ECB	European Central Bank
ERFC	Washington State Economic and Revenue Forecast Council
FDA	Forest Development Account
FEA	Forest Economic Advisors
Fed	U.S. Federal Reserve Board
FOMC	Federal Open Market Committee
FY	Fiscal Year
GDP	Gross Domestic Product
HMI	National Association of Home Builders/Wells Fargo Housing Market Index
IMF	International Monetary Fund
ITC	U.S. International Trade Commission
mbf	Thousand board feet
mmbf	Million board feet
PSP	Paralytic Shellfish Poisoning
PPI	Producer Price Index
Q1	First quarter of year (similarly, Q2, Q3, and Q4)
QE	Quantitative Easing
RCW	Revised Code of Washington
RMCA	Resource Management Cost Account
SA	Seasonally Adjusted
SAAR	Seasonally Adjusted Annual Rate
SLA	Softwood Lumber Agreement
TAC	Total Allowable Catch
USD	U.S. Dollar
WDFW	Washington Department of Fish and Wildlife
WWPA	Western Wood Products Association
WTO	World Trade Organization

Preface

This *Economic and Revenue Forecast* projects revenues from Washington state lands managed by the Washington State Department of Natural Resources (DNR). These revenues are distributed to management funds and beneficiary accounts as directed by statute.

DNR revises its Forecast quarterly to provide updated information for trust beneficiaries and state and department budgeting purposes. Each DNR Forecast builds on the previous one, emphasizing ongoing changes. Forecasts re-evaluate world and national macroeconomic conditions, and the demand and supply for forest products and other goods. Finally, each Forecast assesses the impact of these economic conditions on projected revenues from DNR-managed lands.

DNR Forecasts provide information used in the *Washington Economic and Revenue Forecast* issued by the Washington State Economic and Revenue Forecast Council. The release dates for DNR Forecasts are influenced by the state's forecast schedule as prescribed by RCW 82.33.020. The table below

shows the anticipated schedule for future *Economic and Revenue Forecasts*.

This Forecast covers fiscal years 2019 through 2023. Fiscal years for Washington State government begin July 1 and end June 30. For example, the current fiscal year, Fiscal Year 2019, runs from July 1, 2018 through June 30, 2019.

The baseline date (the point that designates the transition from “actuals” to predictions) for DNR revenues in this Forecast is January 1st, 2019. The forecast numbers beyond that date are predicted from the most up-to-date DNR sales and revenue data available, including DNR's timber sales results through January 2019. Macroeconomic and market outlook data and trends are the most up-to-date available as the Forecast document is being written.

Unless otherwise indicated, values are expressed in nominal terms without adjustment for inflation or seasonality. Therefore, interpreting trends in the Forecast requires attention to inflationary changes in the value of money over time, separate from changes attributable to other economic influences.

Economic Forecast Calendar

Forecast	Baseline Date	Final Data and Publication Date (approximate)
June 2019	May 1, 2019	June 15, 2019
September 2019	August 1, 2019	September 15, 2019
November 2019	October 1, 2019	November 15, 2019
February 2020	January 1, 2020	February 15, 2020

Acknowledgements

The Washington Department of Natural Resources' (DNR) *Economic and Revenue Forecast* is a collaborative effort. It is the product of information provided by private individuals and organizations, as well as DNR staff. Their contributions greatly enhance the quality of the Forecast.

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In the final analysis, the views expressed are our own and may not necessarily represent the views of the contributors, reviewers, or DNR.

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Macroeconomic Conditions

This section briefly reviews macroeconomic conditions in the United States and world economies because they influence DNR revenue—most notably through the bid prices for DNR timber and geoduck auctions and lease revenues from managed lands.

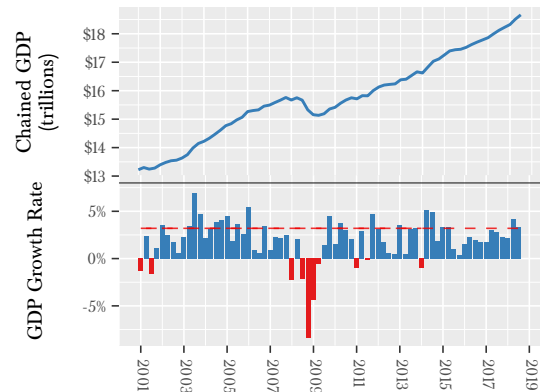
U.S. Economy

Gross Domestic Product

GDP is a useful indicator to track to get an idea of how the U.S. economy is growing overall. When GDP is growing well, then generally there will be an increase in jobs, spending and overall economic welfare. This can translate into growth in housing spending and construction, which influence timber prices and DNR's income from timber. It is a useful indicator of how other, more directly relevant indicators, may move in the future.

Typically, GDP growth experiences a rebound after a recession, spiking to well above the historical average. For instance, after the recession in 1991, GDP grew 3.5 percent in 1992 and continued growing strongly with a peak growth rate of 4.8 percent in 1999. However, this has not been the case since the end of the Great Recession in 2009. From the end of the Great Recession, during which GDP declined in five out of six quarters, to 2017, GDP growth averaged a weak 2.2 percent on a real annualized basis (Figure 4). This is markedly less than the annualized average of 3.2 percent over the previous 50 years (1960-2009). The Great Recession set back economic growth and seriously harmed many sectors of the economy, with especially lasting effects on employment and wages.

Figure 4: U.S. Gross Domestic Product



The pattern of slow GDP growth was widely predicted to break in 2014, then again in 2015, 2016, 2017 and yet again in 2018, with economists expecting or hoping for a rebound. However, as each year progressed expectations were repeatedly reduced.

Many analysts have forecast growth to increase to 2.5-3.0 percent in 2018. With very strong second and third quarter annualized growth of 4.2 and 3.5 percent, respectively, 2018 may have the strongest GDP growth since the end of the recession—with expectations from the FOMC of 3.0-3.1 percent in their December meeting. This is still be less than the historical average.

Predictions for real GDP in 2019 and 2020 are varied, with the FOMC having median predictions of 2.3 and 2.0 percent respectively, while others are more bullish and expect closer to 2.5 percent growth for each year. Predictions for outlying years' GDP growth are perhaps more uncertain than in previous years because it is unclear what the net effect of the 2017 tax reform bill will be and what other economic and trade policies will look like under the current U.S. administration.

In particular, the tax reform bill of 2017 likely put a temporary upward pressure on growth for 2018, with large tax breaks potentially increasing investment and consumption. However, in pushing up growth it also triggered more caution about im-

pending inflation, which encouraged the Fed to increase interest rates, which tend to slow economic growth. Regarding trade policies, some analysts have argued that the strong second and third quarter GDP growth is, in part, the result of the escalating tariff threats. The argument is that foreign buyers stocked up on U.S. exports before the tariffs were put into place, artificially increasing GDP. Additionally, the tariffs and the current U.S. administration's stance on trade will likely lower GDP in the future, though estimates of how much vary widely.

Employment and Wages

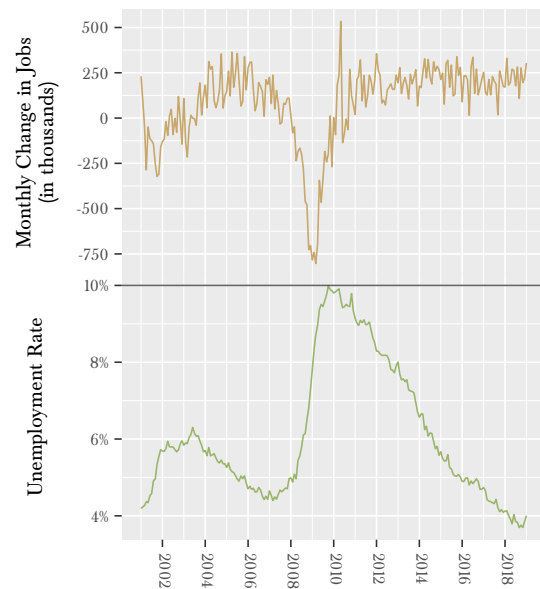
The U.S. headline unemployment rate has been trending downward since peaking at 10 percent in 2010; it hit an 18-year low of 3.6 percent in August 2018 (Figure 5). The unemployment rate rose to 4.0 percent in January from its low point in November of 3.7 percent and is expected to remain in the high-three to low-four percent range through 2020.

Job growth through 2018 averaged 223,000 jobs per month, higher than 2017's average of 182,000 jobs per month. This bucks the trend for the last couple of years which has seen slower job growth, which is expected as the economy gets closer to operating at full capacity. Around 195,000 jobs were created per month in 2016 and 226,000 per month in 2015.¹

The unemployment rate is a useful indicator because it gives insight into slack in the labor market; that is, how many people are available to work before job growth starts driving problematic inflation. The labor market is the driving force behind consumption, which constitutes about 70 percent of GDP and naturally extends to the demand for housing, which is the major driver of U.S. timber demand. Data and anecdotes abound that suggest that one of the major effects of high unemployment rates, particularly among young adults, is lower demand for housing as more people live with their parents or housemates.

¹These job growth numbers are from the BLS Payroll survey. More information can be found here: https://www.bls.gov/web/empst/ces_cps_trends.htm

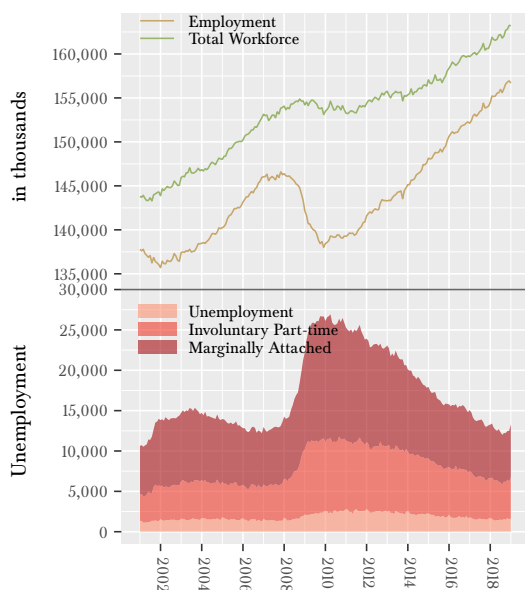
Figure 5: Unemployment Rate and Monthly Change in Jobs



One continual source of consternation for economists over the past year has been the low unemployment rate combined with low inflation. Although the unemployment rate has declined and has been below the long run normal unemployment level expected by the FOMC, it has not yet translated into strong wage growth, which is likely a prerequisite for broader economic improvement and an increase in the demand for housing, or higher inflation. One possible reason for this is that the headline unemployment rate may be underestimating the number of people willing to work. During the 2008-09 recession the number of people who were underemployed or marginally attached to the workforce increased dramatically. Additionally, from the beginning of the recession to mid-2015 the labor force participation rate declined significantly, falling by three percentage points to below 63 percent, where it has remained, possibly because workers left the labor force after they were unable to find jobs.

The U-6 is an alternative measure of unemployment that includes involuntarily part-time employment (underemployment) and marginally attached workers, who are not included in the headline unemployment rate but who, nevertheless, are likely to be looking for work and would benefit from better job prospects. The U-6 has declined from a high of 17.1 percent in 2010 to a low of 7.4 percent in October 2018. This is lower than the average of 9.1 percent from 2001-2006 (Figure 6). The decline in the year-on-year U-6 is the result of a drop in all three of its components.

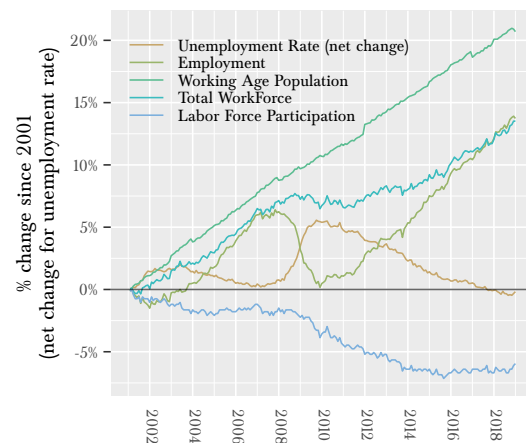
Figure 6: Employment and Unemployment



Reductions in the labor force participation rate helped move the unemployment rate and the U-6 lower roughly through January 2014 (Figure 7). Since then the rate has remained relatively stable between 62.4 and 63.0 percent and has averaged 62.8 percent. The decline in the labor force participation rate is an important confounding factor when examining the unemployment rate and is a key consideration when forecasting whether an increase in employment will trigger an increase in wages and inflation. If there are many people waiting to search for employment until jobs are easier

to find—such as when people stay out of the labor force and the participation rate declines—then as employment grows, more people will enter the labor force and there will be little or no pressure on wages despite a low unemployment rate. However, if people are not in the labor market for other reasons, then the unemployment rate is a more accurate reflection of the labor pool. In that case, a decrease in the unemployment rate means that there are fewer people looking for work, so in order to fill jobs companies will have to compete for labor, pushing up wages.

Figure 7: Labor Market Indicators



The drop in the participation rate since 2008 suggests that the recession itself caused people to leave the labor market, and implies that they may return when things look a bit better. However, Federal Reserve analysts have suggested that the decline in participation may be part of a longer-term trend starting in the late 1970s and pausing during the 1990s, not as a result of the recession. Indeed, according to statistics released by the Federal Reserve Bank of Atlanta, many of those dropping out of the labor force can't or don't want to work.

Inflation

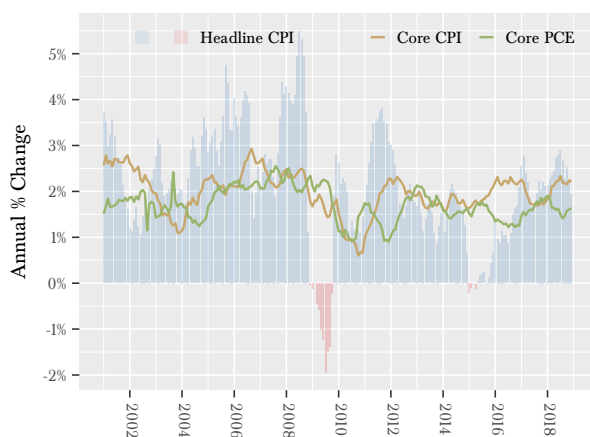
Aside from a short period in 2012, core inflation has been below the FOMC's target since the recession in 2008. Similarly to GDP forecasts, infla-

tion forecasts have been consistently too high, with each year predicted to break the cycle of weak inflation, only to disappoint as the year progresses. (Figure 8).

For policy purposes, the FOMC uses the core Personal Consumption Expenditures (PCE) index as the measure of inflation, which removes the more volatile fuel and food prices. This measure shows long-term inflation at or below the 2.0 percent target since September 2008. Core PCE growth averaged between 1.4 and 1.7 percent from 2015-2017, but has risen to 1.8 percent, year-to-date through November 2018.

The FOMC expects core PCE to be in the low 2.0 percent range in 2019 and 2020.

Figure 8: U.S. Inflation Indices



Interest Rates

Seldom in U.S. history has it been so inexpensive to borrow money for so long. From December 2008 to December 2015, the Federal Reserve held the federal funds rate in the 0.0-0.25 percent range. During that time the Fed pledged to keep the rates near zero until it judged that there had been sufficient progress toward its dual-mandate of maximum employment and around 2.0 percent inflation.

An increase in interest rates will generally slow down economic growth—business investment slows

down because borrowing money becomes more expensive, so job and wage growth slow down (constraining consumption). Similarly, it becomes more expensive for consumers to borrow, impeding demand in the housing and auto markets. In normal times, a decrease in interest rates will expand investment, employment, wages, and consumer credit. The question of whether to raise interest rates is important because it is the key tool of monetary policy.

In December 2015, the FOMC raised interest rates to 0.25-0.5 percent after determining that sufficient progress had been made in the recovery of employment and inflation and, importantly, that there was a sufficiently strong outlook to begin lifting interest rates from their historic lows. From the December 2015 rate rise, the FOMC indicated that they expected a median federal funds rate of 1.4 percent in 2016, which would have been four rate increases of about 0.25 percent. However, this didn't happen due to slower than expected inflation and wage growth. In December 2016 the FOMC raised rates again to 0.5-0.75 percent. The FOMC increased the rate three times in 2017 and five times in 2018, leading to current rates of 2.25-2.5 percent. These increases were widely expected because the FOMC carefully prepared markets for it with each successive meeting statement.

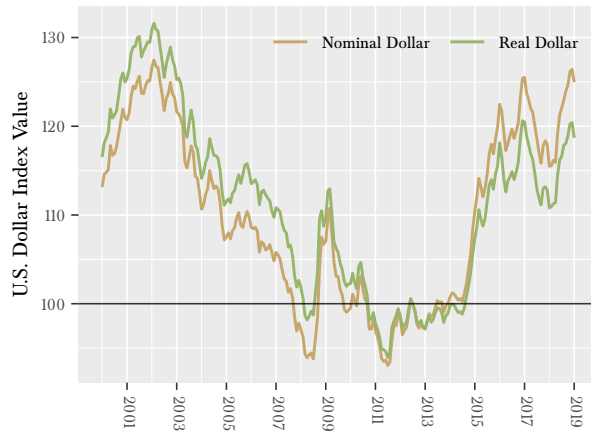
According to the December projections, the FOMC expected to raise interest rates again one to two times in 2019, leading to a federal funds rate between 2.6 and 3.1 percent, with further increases leading to 2.9-3.4 percent rates in 2020. This is a drop from the June 2018 projections, which showed an expected funds rate between 2.9-3.4 percent in 2019 and 3.1-3.6 in 2020.

The U.S. Dollar and Foreign Trade

The trade-weighted U.S. dollar index climbed dramatically from 2014 through late 2016. Through 2015 and 2016 this was largely due to the relative strength of the U.S. economy, which, although fairly weak, was growing faster than most other advanced countries. Although the value of the U.S. dollar was below its 2015 peak for most of 2016, the results of

the U.S. presidential election pushed the exchange rate well above its previous high. From mid-2017 to May 2018, the dollar dropped back to around its 2015 start; however, since May 2018 it increased above its earlier 2016 high (Figure 9).

Figure 9: Trade-Weighted U.S. Dollar Index



A rising dollar means that timber and lumber from the Pacific Northwest become more expensive for international buyers and imported timber and lumber become less expensive. This will tend to suppress local prices and DNR's timber and agricultural revenues. Wildstock geoduck revenue will also be negatively affected because geoduck is primarily marketed abroad. A falling dollar leads to the opposite effects.

Foreign trade and access to export markets is important for DNR revenues. Chinese demand for timber and lumber have been a major factor supporting lumber prices since 2010, even though DNR timber cannot be exported directly and Chinese demand has been declining. Additionally, much of the soft white wheat produced in Washington is exported to Asia and a large portion of the PNW geoduck harvest is exported to China.

Given the proposed policies of the U.S. administration, the upcoming months and years are likely to be more volatile for foreign trade and present a large potential downside risk for DNR revenue. Although it appears that the burgeoning 'trade wars'

with Canada and Mexico have been resolved, with large tariffs have proposed or imposed on a range of imports from China and the EU. This has resulted in some countries imposing tariffs on U.S. goods.

Initially, the foreign tariffs implemented by China seemed designed to target products produced primarily in states that heavily support the U.S. administration. These include a slew of agricultural commodities, such as wheat, nuts, apples, soybeans, peanut butter, and pork, as well as other commodities such as steel and aluminum, and some finished goods, such as bourbon.

The effects of the tariffs DNR revenue will be negative, though it appears that they are not negative enough to outweigh higher revenue in some sources. For instance, apples will have a 15% tariff when exported to China. This will likely reduce the demand in China for U.S.-grown apples and potentially push down prices here, leading to lower revenue from crop-sharing leases, as well as undermine lease adjustments in the future, which are tied to the price index for agricultural products. However, irrigated agriculture has had strong revenue in FY19 to-date, seemingly outweighing any negative effects of the tariff.

Trade tension between the U.S. and China appear to have eased, with reports of successful, though inconclusive, meetings between the countries' representative.

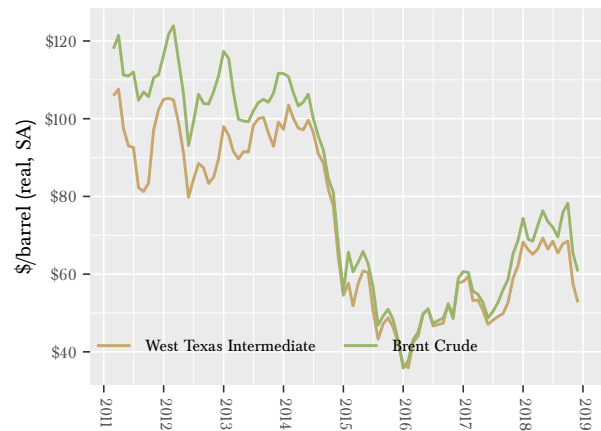
Of the tariffs still in effect, softwood timber and lumber don't appear to be on any of the tariff lists, though some processed softwood products are. Chinese timber exports have already fallen from a peak of 4.1 million m³ in 2011 to 1.7 million m³ in 2017 (unrelated to tariffs). Analysts had been predicting that increases in domestic demand will offset the drop in Chinese demand, however, there would still be a large drop in overall demand if China were to turn away from Washington log and lumber exports entirely.

Previously, some analysts argued that access to wheat and other agricultural export markets are not in any serious danger because our largest trading partners are dependent upon imports to satisfy

their demand and food prices in developing countries are highly political. However, that doesn't mean that they aren't able to preferentially purchase from U.S. competitors, particularly Australia, which is the world's largest exporter of soft white wheat.

Finally, China is apparently the primary market for geoducks so an increase in geoduck prices in the Chinese market could have a large impact². The average prices of the two geoduck auctions since the imposition of tariffs have been around 25 percent lower than those of the recent past, suggesting that the tariffs are having a meaningful impact.

Figure 10: Crude Oil Prices



Petroleum

Crude oil and its derivatives strongly affect production, transportation, and consumption in the world and U.S. domestic economies. Prices for Brent crude oil plummeted from \$108/barrel in January 2014 to \$30/barrel in January 2016, a 70 percent drop. Prices spiked in late 2017 to \$64/barrel—its highest price since January 2015. Prices stabilized between \$70-\$80/barrel (seasonally adjusted) between April and August, before spiking to above \$85/barrel in late September. However, prices dropped dramatically through October and early November, falling from the September peak to just above \$65/barrel - roughly 25 percent.

Broadly, a drop in oil prices acts like a tax cut for consumers and can encourage consumption. Additionally, all other things being equal, lower petroleum prices will decrease diesel fuel prices and will make transportation-sensitive industries—such as PNW logging and agriculture—more competitive in international markets. However, all other things are not equal: as discussed above, the U.S. dollar has started to increase again, which will make PNW timber more expensive internationally, while tariffs are being introduced, making it less competitive still.

²There is very little information about the geoduck market, so much of our understanding is anecdotal.

China

China is a major export market for logs, lumber, geoduck, and wheat and other agricultural products from the Pacific Northwest. Since 2011, between 50 and 60 percent of the softwood log exports leaving the Seattle and Columbia River Customs District have gone to China. Additionally, China is (anecdotally) the primary export market for Washington's geoduck. Changes to the Chinese economy can have a dramatic impact on the prices for logs, lumber, and geoduck in the Pacific Northwest.

China's GDP and employment weathered the global economic and financial crises better than most other economies. However, concerns are growing that that resilience may still prove to be illusory, as the costs of propping up investment and maintaining significant political control over the economy mount and the likelihood of a dramatic slowdown increase. Chinese GDP growth slowed from 10.4 percent in 2010 to 6.9 percent in 2017, with reports of the 6.6 percent reported growth of 2018 being highly questionable given other economic indicators.

There is some concern that Chinese GDP growth will fall much lower, possibly even into recession, with some analysts looking out for a Minsky moment—a sudden sharp drop in economic activity

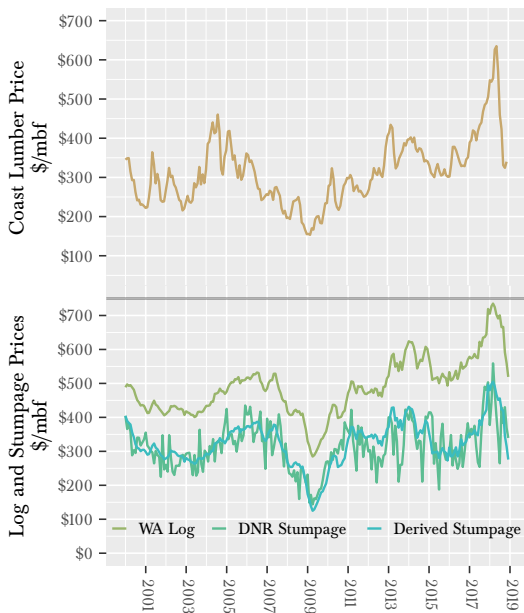
triggered by excess debt. This risk is mostly due to the prominence of investment as a component of GDP, the huge amount of debt in the country, and the way that debt is held. Household and corporate debt (to non-financial corporations) ballooned from about 110 percent of GDP in 2008 to over 190 percent in 2014, and much of it is linked to real estate. Investment comprises almost 50 percent of China's GDP. At those levels of debt a slowdown in an economy can lead to a drop in income and an inability to service debt en-masse, potentially leading to a debt crisis that would undermine that investment and have a tremendous impact on China's GDP.

The concern about the overall economy is amplified by the U.S. administration, which has been very critical of trade with China and has imposed tariffs on Chinese goods. China is particularly vulnerable to changes in access to international markets, with exports making up 25 percent of its GDP and a large proportion of employment dependent upon labor-intensive export industries.

Wood Markets

Over the past decade, timber stumpage revenue has constituted about 70 percent of total DNR revenues. DNR is, therefore, vitally concerned with understanding stumpage prices, log prices, lumber prices, and the related supply and demand dynamics underlying all three. This section focuses on specific market factors that affect timber stumpage prices and overall timber sales revenue generated by DNR.

Figure 11: Lumber, Log, and Stumpage Prices in Washington

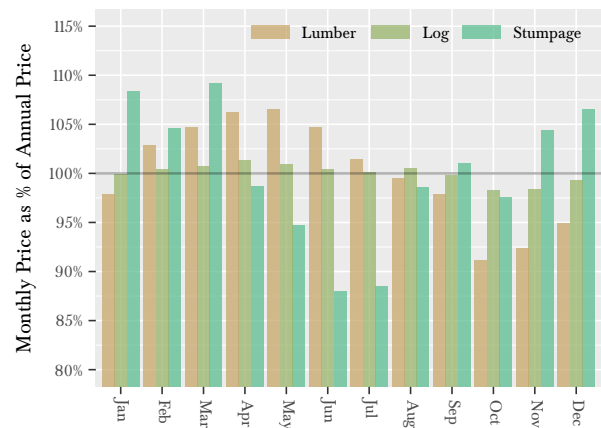


In general, timber stumpage prices reflect demand for lumber and other wood products, timber supply, and regional lumber mill capacity. There is a consistent, positive relationship between log prices and DNR's stumpage prices, despite notable volatility in stumpage prices (Figure 11). High log prices make access to logs more valuable, increasing purchasers' willingness to pay for stumpage (the right to harvest). Volatility in stumpage prices arise not only from log prices, but also from the volume of lumber and logs held in mills' inventories and from DNR-specific issues, such as the quality and type

of the stumpage mix offered at auction, the region, and the road-building requirements of a particular sale.

The relationship between lumber and log prices is less consistent. Lumber prices are significantly more volatile and both the direction and size of price movements can differ from log prices. This is due to both demand and supply-side factors. On the demand side, mills will often have an inventory of logs in their yards, as well as an inventory of 'standing logs', so they do not always need to bid up stumpage prices to take advantage of high lumber prices. From the supply side, land owners often do not need to sell their timber, so when prices fall too far, they can withhold supply and allow their trees to grow and increase in quality.

Figure 12: Lumber, Log, and DNR Stumpage Price Seasonality



There are differences in price seasonality between lumber, logs, and stumpage, as illustrated in Figure 12. These prices are affected by a degree of seasonality that is largely the result of when each of these commodities will be used. For instance, lumber prices tend to peak in spring, when housing construction picks up, and decline through fall as demand wanes, while stumpage prices tend to be highest in January-March, when harvesters are lining up harvestable stock for the summer. DNR stumpage price volatility is also affected by the fire-fighting season and the quality of the stumpage

mix, which varies throughout the year but tends to be lower from July through September.

U.S. Housing Market

This section continues with a discussion of the U.S. housing market because it is particularly important to overall timber demand in the U.S.

New residential construction (housing starts) and residential improvements are major components of the total demand for timber in the U.S. Historically, these sectors have constituted over 70 percent of softwood consumption—45 percent going to housing starts and 25 percent to improvements—with the remainder going to industrial production and other applications.

The 2007 crash in the housing market and the following recession drastically reduced demand for new housing, which undermined the total demand for lumber. Since the 2009-11 trough, the increase in housing starts has driven an increase in lumber demand, though not to nearly the extent of the peak. Prolonged growth in starts is essential for a meaningful increase in the demand for lumber.

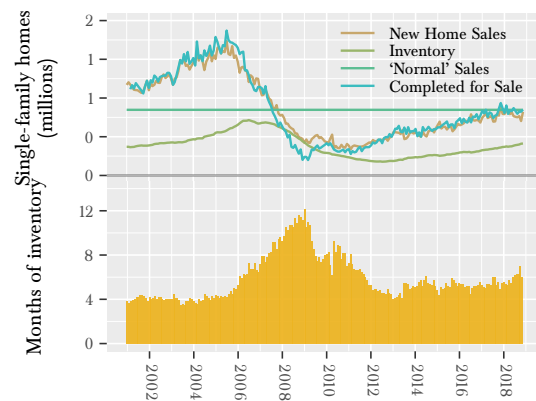
After stalling through late 2014, housing demand grew through mid-2018, though its growth was subdued by tight lending standards and increasing prices at the same time as stagnant or declining real wages for much of the population. Although lending standards have relaxed a little and the labor market is tightening, these improvements have not yet been sufficient to meaningfully increase housing demand.

New Home Sales

Unsurprisingly, new home sales plummeted during the recession, reaching a record low of 306,000 (SAAR) in 2011 before beginning a slow rise (Figure 13). New home sales increased from 440,000 (SAAR) in 2014 to an average of 502,000 in 2015. The monthly sales for 2016 averaged 561,000 homes, still well below the long-term (1963-2010) ‘normal’ rate of 678,000 sales per year. New home

sales in 2017 averaged an annualized 616,000. New home sales averaged 651,000 (annualized) through May 2018, before dropping meaningfully to average 609,000 for June-November.

Figure 13: New Single-Family Home Sales

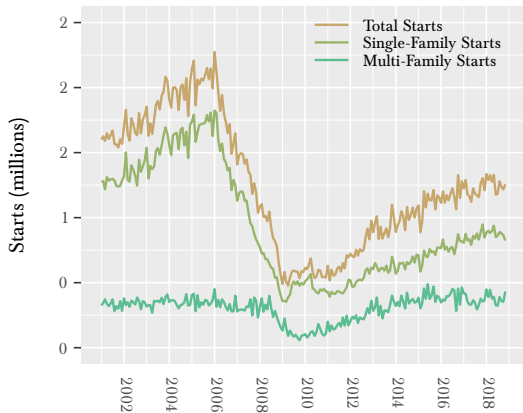


As low as new home sales fell, new home construction fell even lower from early 2007 through mid-2011, causing the inventory of newly built homes for sale to decline over the period. After bottoming out in July 2012 at 142,000 units, the inventory of new homes has crept up as construction slightly outpaced sales and averaged 276,000 units in 2017. To-date 2018 inventory is higher through November at 310,000 units.

Housing Starts

In April 2009, U.S. housing starts fell to record lows since the Census Bureau began tracking these data in 1959. U.S. housing starts picked up in 2011 and continued to rise, largely because of increases in multi-family starts. Single-family starts were more or less flat after the recession through 2012, but have been rising slowly since (Figure 14).

Figure 14: Housing Starts



Since the recession, total housing starts have been made up of a larger portion of multi-family units than in the past. This is pertinent because multi-family structures use much less lumber than single-family houses per unit, so the slow recovery in overall starts has had a more muted effect on timber prices than historical increases. However, it is not clear how long multi-family starts will drive total starts: in 2016 multi-family starts were lower than in 2015, 385,000 and 395,000 starts respectively, while single family starts increased from 718,000 to 783,000 (SAAR). In 2017, multi-family starts declined further, averaging 356,000 starts (annualized), while single-family starts averaged 852,000. Through November 2018, starts averaged an annualized 879,000 single family starts and 345,000 multi-family starts.

The recovery in house prices should facilitate the ‘move-up’ market, where homeowners sell their current home in order to buy a larger, more expensive one. An increase in the move-up market combined with low total inventories constraining the supply of existing housing should in general put upward pressure prices and provide incentives to build more houses. While that seems to be happening to a certain extent, its effect appears to be limited because the price increases themselves are keeping people from the lower end of the market, meaning that prices have risen so much that homeowners are beginning to have difficulty selling at market

rates.

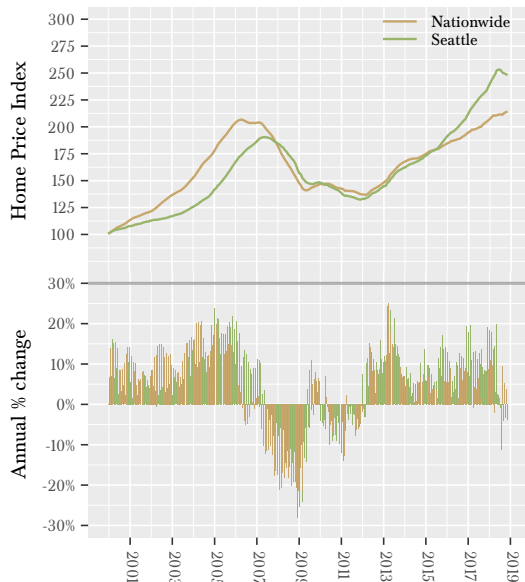
Builder confidence is no longer an impediment to housing starts, as estimates of confidence are consistent with housing starts of over 1 million. However, there are significant supply impediments, such as the shortage of buildable lots and permit delays. Given the lead time necessary to build houses, these are likely to cause volatility in both prices and supply.

Housing Prices

U.S. housing experienced six unprecedented years of falling or flat prices following the recession. House prices started rising again only in 2012 as economic and employment indicators continued to improve. Figure 15 charts the seasonally adjusted S&P/Case-Shiller Home Price Index for the 20-city composite, which estimates national existing home price trends. The 20-city composite index has increased in most months since bottoming out in January 2012—its lowest point since October 2002.

Nationally the Case-Shiller Index growth has slowed significantly since May and the Seattle index actually decreased between July and November, though November prices are still up five percent year-on-year. Seattle house prices had been growing much faster than national prices, increasing 11.7 percent year-on-year as of December 2017, compared with 6.3 percent nationally. When Seattle prices bottomed in February 2012—their lowest point since June 2004—the average existing house in Seattle was worth only 70 percent of the May 2007 peak. Despite the recent decrease in prices, as of November, the average Seattle home was worth over 30 percent more than its peak price before the recession (in nominal terms).

Figure 15: Case-Shiller Existing Home Price Index



Export Markets

Although Federal law prohibits export of logs from public lands west of the 108th meridian, log exports still have a meaningful impact on DNR stumpage prices. Exports compete with domestic purchases for privately sourced logs and strong export competition pulls more of the supply from the domestic market, thereby raising all domestic prices. However, changes in export prices do not influence domestic prices in a one-to-one relationship.

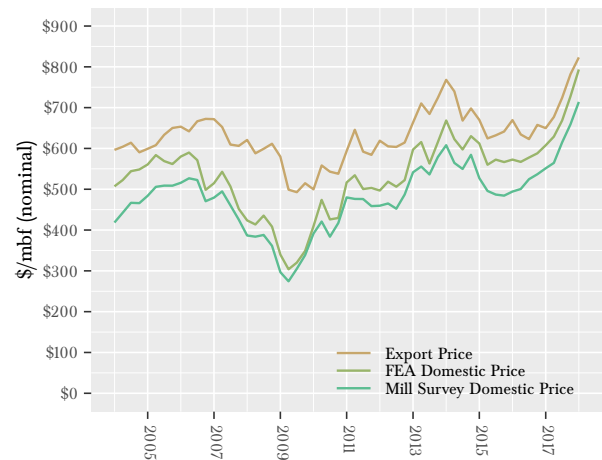
Export prices are almost always higher than domestic prices, a difference which is referred to as the ‘export premium’ (Figure 16). The export premium is primarily due to the characteristics of the export markets, which can include a demand for higher quality wood, a high value placed on long-term contracts, and high transaction costs.

Note that the export prices shown in Figure 16 are weighted by DNR’s typical species mix, not the species mix of actual export volumes.

Since 2010, demand from China has been a major support for log and lumber prices in Washington.

That demand dropped in late 2014 as China’s economic health wavered, the U.S. dollar appreciated while the value of the euro and ruble dropped (making U.S. timber comparatively more costly), and a 25 percent Russian tariff on log exports was reduced. The downward trend in demand continued through 2015, with Douglas-fir log exports down 46 percent and hemlock (and other whitewood) exports down 33 percent from 2014 (Figure 17). Exports to China from the Seattle and Columbia-Snake River Customs Districts for both Douglas-fir and Hemlock were 11 percent lower in 2016 than 2015, 1.9 million m³, compared to 2.1 million m³ in 2015 and 3.2 million m³ in 2014.

Figure 16: Log Export Prices

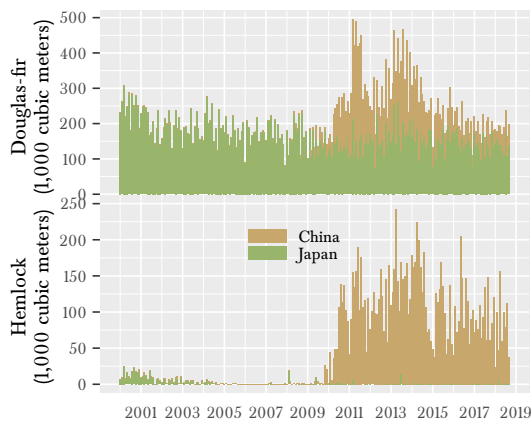


The trend of decreased exports to China continued in 2017 with hemlock exports from Seattle and the Columbia River Customs Districts falling from a peak of 1.7 million m³ in 2014 to 1.1 million m³ in 2017 and douglas-fir export falling from 2.2 million m³ in 2013 to 0.6 million m³ in 2017. Export volumes to Japan are down around 3.0 percent year-to-date through September, and down to China around 9.0 percent.

The export premium appears to have shrunk since 2014 due to strong demand from recovering domestic markets and decreased demand from importing countries, China in particular. In the long run, the export premium may shrink more yet further as West Coast log exports face stronger international

competition and export prices are pushed down. Much will depend on supply constraints from key international suppliers, transportation constraints from the southeastern U.S, and whether tariffs are imposed on softwood logs.

Figure 17: Log Export Volume



Timber Supply

Since the beginning of the recession timber growth throughout the U.S. has generally exceeded timber harvest, increasing the timber inventory. However, strong log exports from the West Coast drove up harvests, so that inventory growth was slower than in other parts of the country, particularly the U.S. South. Harvests have rebounded strongly enough that timber harvest began to exceed growth in 2017, so the standing timber inventory is beginning to fall. Drawing down the standing timber inventory will constrain the region's ability to expand outputs—although harvests are expected to continue to increase for several years, they will not reach the levels of the mid-2000s, nor will the increased harvest push prices down.

Since the late 1990s British Columbian forests have been devastated by the mountain timber beetle, which affected about a third of the province's timber resources. Typically, timber killed by beetles must be harvested within 4 to 10 years so in 2007 the government increased the allowable harvest to ensure that the dead timber was not wasted, which in-

creased British Columbia's harvestable timber supply. These elevated timber supplies are already declining.

Most of the remaining beetle kill is now unviable and there will be no harvestable beetle kill after 2020. The supply from Canada will be further diminished by Quebec's allowable annual cut being reduced by Bill 57, which was implemented in April 2013, and may be additionally reduced by the 'North for All' plan (formerly Plan Nord).

Price Outlook

Lumber Prices

As shown in Figure 11, lumber prices dropped precipitously from mid-2014 to mid-2015, before leveling off. FEA's coast lumber price peaked at \$402/mbf in May 2014, but fell throughout the rest of the year to average \$376/mbf. This was largely due to a bitterly cold winter across much of the U.S. which weakened domestic demand, ample local timber and lumber inventories, and the drop in export demand from China. Prices in 2015 continued their general downward trend and ended the year averaging \$317/mbf. Prices increased in 2016 to average \$341/mbf and increased sharply in 2017 to average \$425/mbf. In June 2018, prices hit \$635/mbf, higher in real terms than any since 2000. However, from June prices dropped dramatically to a low of \$324/mbf in November—a 47 percent drop. December prices were up slightly at \$340/mbf, leading to an average \$488/mbf in 2018.

A drop in prices at the end of the third quarter 2018 was expected due to the end of the building season and increased supply from additional capacity being put online, but this drop was much larger than expected. In outlying years prices are expected to remain around the 2017 average, but will not reach the peaks of 2018.

Log Prices

Figure 18 presents prices for Douglas-fir, hemlock, and DNR's composite log. The latter is calculated from prices for logs delivered to regional mills, weighted by the average geographic location, species, and grade composition of timber typically sold by DNR. In other words, it is the price a mill would pay for delivery of the typical log harvested from DNR-managed lands. The dark green line for the DNR composite log price on Figure 18 is the same as the light green line on Figure 11.

Readily visible on the graph is the decline in the premium for Douglas-fir—due in large part to Chinese demand fortifying hemlock prices. Also readily visible is the drop in prices from late 2014 to early 2016. The price of a 'typical' DNR log moved up sharply from a two-year plateau in 2013 to \$591/mbf in 2014. However, prices declined through 2015 to average \$521/mbf. The decline in log price was primarily due to the slowdown in demand from China and ample regional supply of both logs and lumber.

Log prices in 2016 increased to average \$536/mbf and jumped even higher in 2017 to \$611/mbf. Log prices peaked in July at \$701/mmbf, before also falling precipitously to \$519/mbf in December.

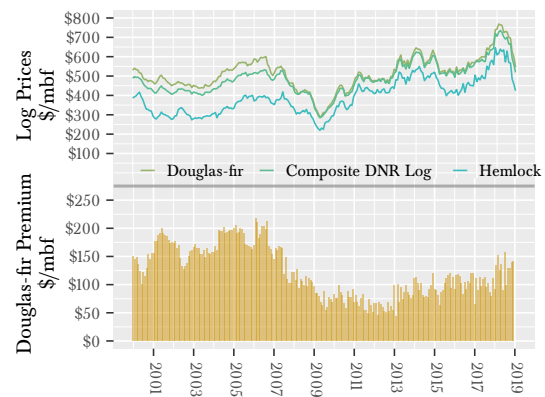
Stumpage Prices

Timber stumpage prices are the prices that successful bidders pay for the right to harvest timber from DNR-managed lands (Figure 19). At any time, the difference between the delivered log price and DNR's stumpage price is equivalent to the sum of logging costs, hauling costs, and harvest profit (Figure 11). Subtracting the average of these costs from the log price line gives us a derived DNR stumpage price.

When actual DNR stumpage prices differ significantly from the derived stumpage prices, a correction is likely to occur. For instance, in 2012 actual stumpage prices were generally lower than stumpage prices inferred from log prices, suggest-

ing that an upward market 'correction' would be forthcoming. This correction seems to have occurred with generally higher stumpage in 2013 and 2014. However, the situation reversed in late 2014, when actual DNR stumpage prices were well above the inferred stumpage prices. In the November forecast, we noted that DNR actual stumpage prices were well above the inferred prices, suggesting that stumpage prices would be lower in the near future. That was correct—prices moved sharply lower in from an October auction high of \$430/mbf, to a December auction average of \$340/mbf. However, the derived stumpage has continued to fall, suggesting that we may see even weaker average prices in the next several months.

Figure 18: DNR Composite Log Prices

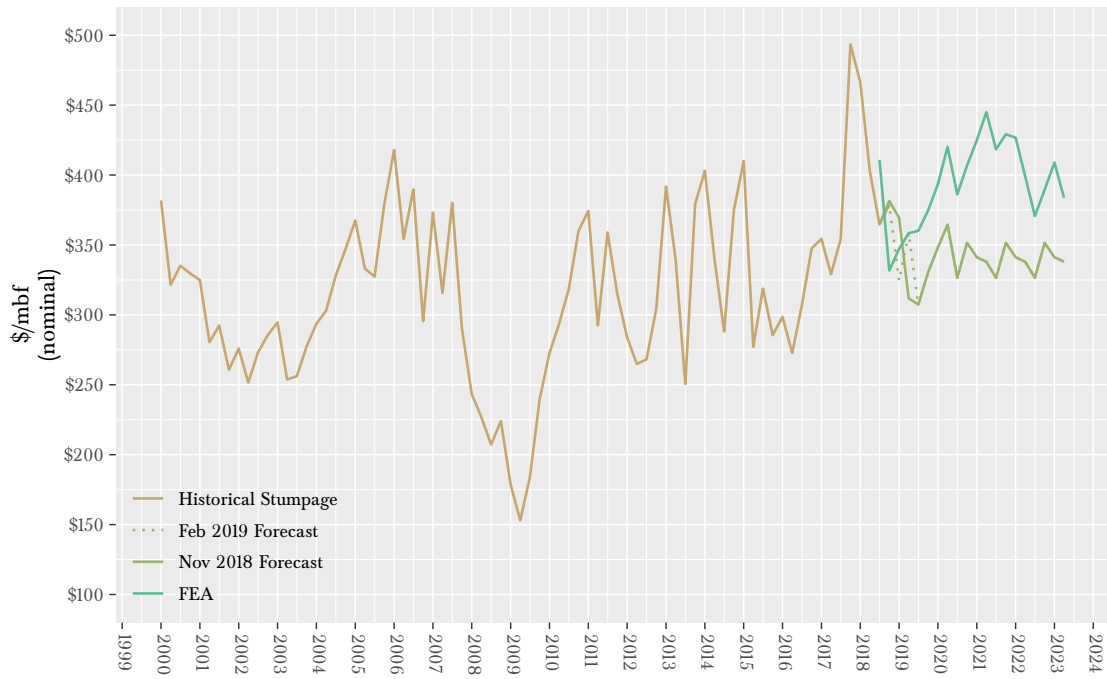


DNR Stumpage Price Outlook

DNR currently contracts with a forest economics consulting firm that provides log and timber stumpage price forecasts, as well as valuable insights into the housing, lumber, and timber markets. By modeling DNR's historical data on its price forecasts, we arrive at a stumpage price outlook (Figure 19, note that the FEA 'forecast' series reflects the species and class characteristics of typical DNR timber; the original series were West Coast averages, and are not shown).

It is important to note that these are nominal price expectations.

Figure 19: DNR Timber Stumpage Price



DNR Revenue Forecast

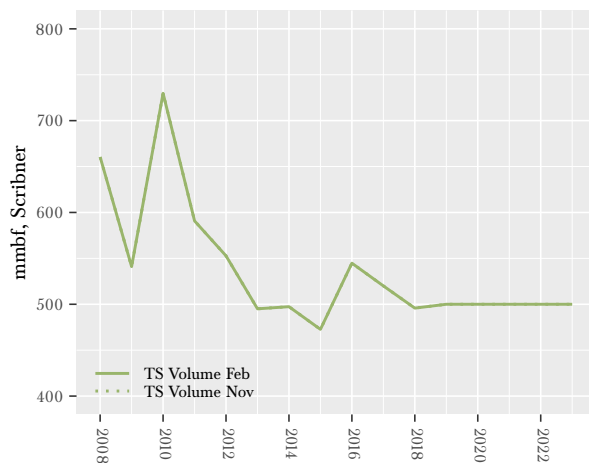
This Revenue Forecast includes revenue generated from timber sales on trust uplands, leases on trust uplands, and leases on aquatic lands. It also forecasts revenues to individual funds, including DNR management funds, beneficiary current funds, and beneficiary permanent funds. Caveats about the uncertainty of forecasting DNR-managed revenues are summarized near the end of this section.

Timber Revenue

DNR sells timber through auctioned contracts that vary in duration. For instance, contracts for DNR timber sales sold in FY 2014 needed to be harvested between three months and four and a half years from the date of sale, with an average (weighted by volume) of about 25 months. The purchaser determines the actual timing of harvest within the terms of the contract, which is likely based on perceptions of market conditions. As a result, timber revenues to beneficiaries and DNR management funds lag behind sales.

For the purposes of this chapter, timber that is sold but not yet harvested is referred to as ‘inventory’ or ‘under contract’. Timber volume is added to the inventory when it is sold and placed under contract, and it is removed from the inventory when the timber is harvested.

Figure 20: Forecast Timber Sales Volume

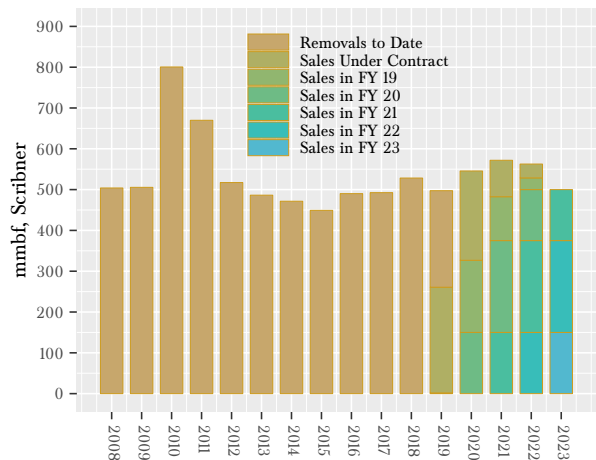


Timber Sales Volume

Sales volume forecasts for all years are unchanged (Figure 20). This is despite a recent increase in the number of contracts that were offered at auction that were passed-in with no bids. DNR plans on offering for auction more than 500 mmbf, but our volume forecast builds in the probability that some of those contracts offered will not be sold in this fiscal year.

FY15 was the first year of the new sustainable harvest decade (FY15 through FY 24) for Western Washington; however, new harvest targets for this sustainable harvest decade have not yet been determined or approved by the Board of Natural Resources. Without an updated sustainable harvest limit, annual Westside sales volumes are forecast to be 450 mmbf for future years. Together with projected Eastside timber sales of 50 mmbf for each of the next several years, we arrive at a projected annual timber sales volume of about 500 mmbf for FYs 19-23.

Figure 21: Forecast Timber Removal Volume



Timber Removal Volume

For each forecast, we survey timber sale purchasers to determine their planned harvest timing for the timber volume they have under contract at the time of the survey. Given an updated purchaser survey harvest schedule and harvests to-date through

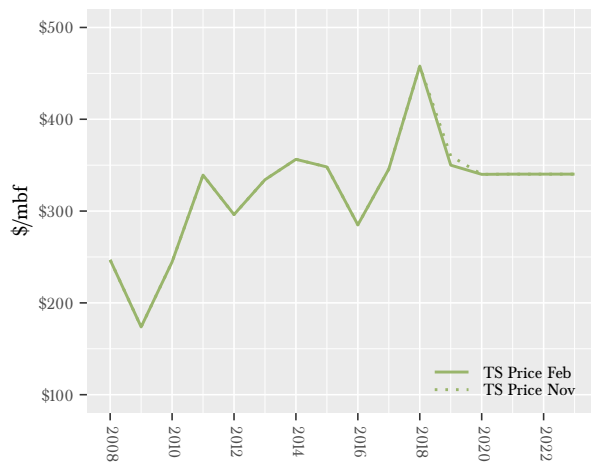
November, FY19 removal volume is forecast to total 520 mmbf—a decrease of 30 mmbf from the November forecast. This change is due to harvests to-date being much slower than suggested by previous purchaser surveys, as well as the price drop in both lumber and log prices.

A portion of sales from FY19 and current inventory are expected to be harvested in outlying years (see Figure 21).

Timber Sales Prices

The price results of monthly DNR timber sales are quite volatile (Figure 11). As discussed in the stumpage price outlook, the DNR sales price (stumpage) forecast uses estimates from a forest economics consulting firm. The sales price forecast for FY 19 is decreased by \$10/mbf to \$350/mbf. The drop in prices in the latter half of 2018 has diminished expectations for the rest of the year, despite several auctions with higher average prices. The forecasts in outlying years are unchanged as they have already incorporated downside risks to the market.

Figure 22: Forecast Timber Sales Price



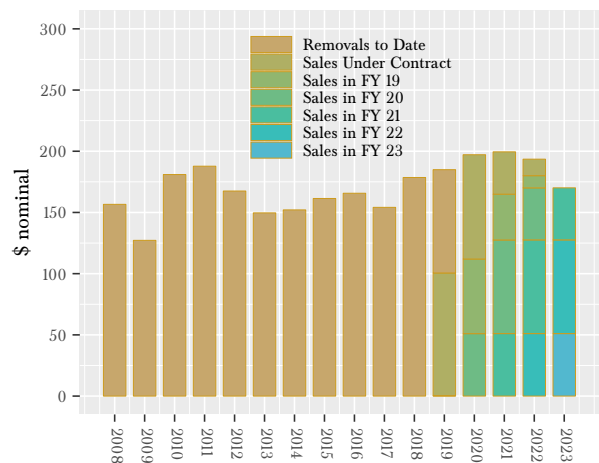
Timber Removal Prices

Timber removal prices are determined by sales prices, volumes, and harvest timing. They can be thought of as a moving average of previous timber sales prices, weighted by the volume of auctioned timber removed in each time period (Figure 23). Removal prices in FY19 are lower by \$7/mbf due to lower sales prices in this year and an increase share of removals from lower valued sales. Removal prices in outlying years are also decreased slightly.

Figure 23: Forecast Timber Removal Price



Figure 24: Forecast Timber Removal Value

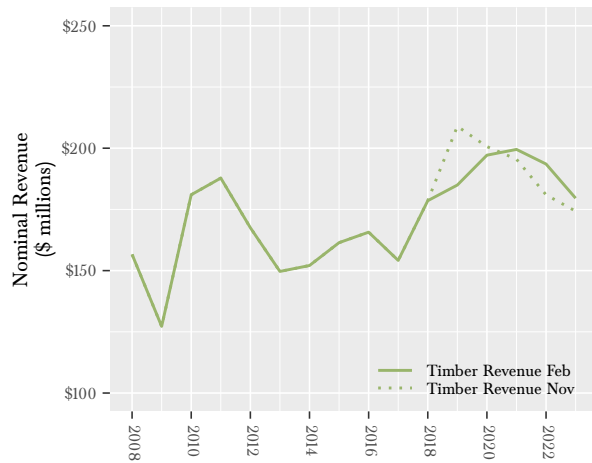


Timber Removal Revenue

Figure 24 shows projected annual timber removal revenues, broken down by the fiscal year in which the timber was sold ('sales under contract' were sold as of January 1st, 2019). Revenue estimates reflect all of the changes described above.

Projections for the 2017-2019 biennium are \$372 million, a decrease of about \$15 million (3.9 percent) from the forecast in November, and \$397 million for the 2019-2021 biennium, an increase less than \$1 million (0.1 percent).

Figure 25: Forecast Timber Removal Revenue

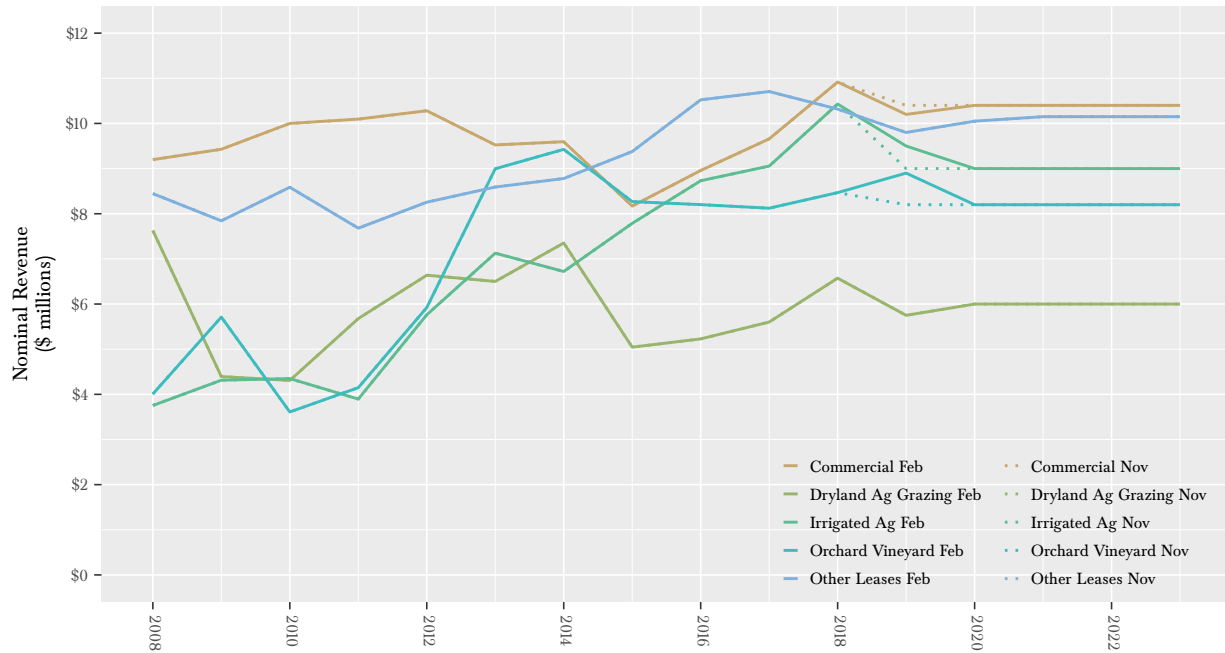


Upland Lease Revenues

Upland lease revenues are generated primarily from leases and the sale of valuable materials, other than timber, on state trust lands (Figure 26). Projected revenue from irrigated agriculture is increased by

\$0.5 million and from orchard/vineyard by \$0.7 million due to strong revenues to-date. Revenue projections for commercial leases are reduced by \$0.2 in FY19 due to maintenance costs offsetting some revenue. Revenue forecasts for all other sources remain unchanged.

Figure 26: Forecast Upland Lease Revenue



Aquatic Lands Revenues

Aquatic lands revenues are generated from leases on aquatic lands and from sales of geoduck. On average, leases account for one-third of the revenue while geoduck sales account for the remainder.

The aquatic lease revenue forecast is increased for FY19 due to higher than expected revenue in both water-dependent and non-water-dependent leases (Figure 27). Projected revenue in outlying years is increased for non water-dependent rents, which appear to conservative given the recent revenue history.

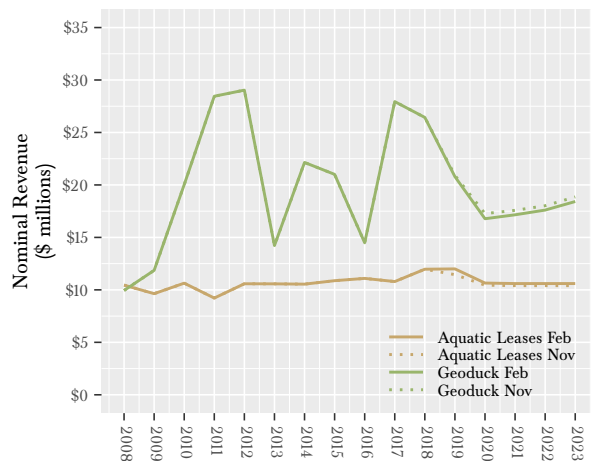
The geoduck revenue forecast for FY19 has been increased slightly based on updated harvest volumes (Figure 28). Outlying years forecasts are unchanged.

higher than the average in 2014. However, given the historical volatility of the market, it is imprudent to increase the outlying years’ auction price forecasts too much, so the auction price forecasts are one standard error below the mean forecasted model in outlying years.

There are significant downside and upside risks to geoduck revenues, even in the near term, that are important to consider but difficult to forecast. On the downside:

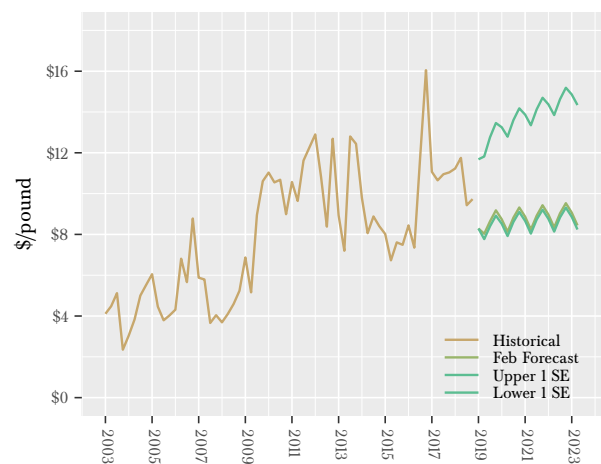
- Harvests (and therefore revenues) could be deferred or lost if geoduck beds are closed due to occurrence of paralytic shellfish poison.
- A further slowdown in China’s economic growth or the tariffs on geoduck could lower demand for this luxury export in its largest market.
- In light of recent WDFW surveys of closed South Puget Sound geoduck tracts showing declining recovery rates, and of evidence of active poaching, future commercial harvest levels may be further reduced.

Figure 27: Aquatic Lands Revenues



Starting in Q2 2014, our geoduck price forecasts were consistently high and prices seemed to enter a period of fairly low volatility. This suggested that there may have been some change in the equilibrium price of geoduck—that the lower prices weren’t just part of the natural volatility of the market, but a fundamental shift in the price level. The consistently higher auction prices since August 2016, threw that hypothesis into question and suggested that a new price level was somewhat

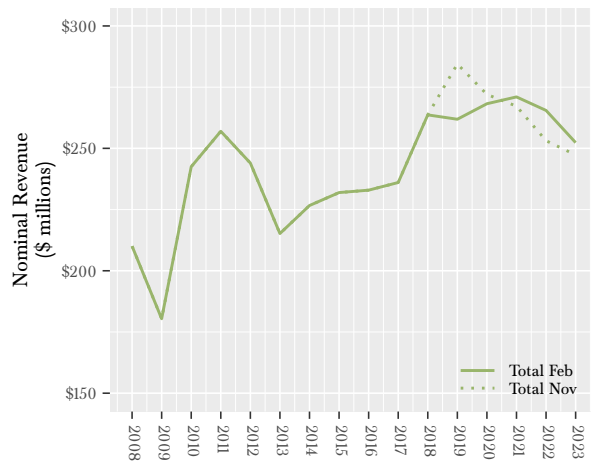
Figure 28: Geoduck Auction Prices



Total Revenues from All Sources

Forecast revenues for the 2017-2019 biennium are decreased to \$535 million, while revenues for the 2019-2021 biennium are increased by \$1 million to \$540 million (Figure 29).

Figure 29: Total Revenues



Some Caveats

DNR strives to produce the most accurate and objective projections possible, based on DNR's current policy directions and available information. Actual revenues will depend on future policy decisions made by the Legislature, the Board of Natural Resources, and DNR, as well as on market and other conditions beyond DNR's control.

See the Forecast Summary for more details.

Distribution of Revenues

The distribution of timber revenues by trust are based on:

- The volumes and values of timber in the inventory (sales sold but not yet harvested) by trust;
- The volumes of timber in planned sales for FYs 19-20 by trust, and relative historical timber prices by DNR region by trust; and
- The volumes of timber by trust for FYs 22-23 based on provisional output of the sustainable harvest model and relative historical timber prices by DNR region by trust.

Since a single timber sale can be worth more than \$3 million, dropping, adding, or delaying even one sale can represent a significant shift in revenues to a specific trust fund.

Distributions of upland and aquatic lease revenues by trust are assumed to be proportional to historic distributions unless otherwise specified.

Management Fee Deduction. The underlying statutory management fee deductions to DNR as authorized by the Legislature are 25 percent or less, as determined by the Board of Natural Resources

(Board), for both the Resources Management Cost Account (RMCA) and the Forest Development Account (FDA). In biennial budget bills, the Legislature has authorized a deduction of up to 30 percent to RMCA since July 1, 2005. In 2015, they authorized a deduction up to 31 percent.

At its April 2011 meeting, the Board adopted a resolution to reduce the RMCA deduction from 30 to 27 percent and the FDA deduction from 25 to 23 percent. At its July 2011 meeting, the Board decided to continue the deductions at 27 percent for RMCA (so long as this rate is authorized by the Legislature) and at 23 percent for FDA. At its October 2011 meeting, the Board approved a resolution to reduce the FDA deduction from 23 to 21 percent. The Board decided in July 2013 to raise the FDA deduction to 25 percent and the RMCA deduction to 29 percent. In August 2015 the Board raised the RMCA deduction up to 31 percent for the 2015-2017 biennium.

The Forecast uses the 31 percent deduction for the 2017-2019 and 2019-2021 biennia. This assumes that the Legislature will approve RMCA deductions of up to 31 percent.

Given this background of official actions by the legislature and the Board, the management fee deductions assumed in this Forecast are:

	FY 19	FY 20	FY 21	FY 22	FY 23
FDA	25	25	25	25	25
RMCA	31	31	31	31	31