

Department of Natural Resources
Economic & Revenue Forecast

Fiscal Year 2017, Second Quarter
November 2016



Forecast Summary

Lumber and Log Prices. Lumber and log prices have fallen markedly since peaking in 2014. Random Lengths' Coast Dry Random and Stud composite lumber price peaked at \$393/mbf in January 2014, but fell throughout the rest of the year to average \$373/mbf. The lumber index continued to fall to average \$311/mbf for 2015. Prices have averaged \$328/mbf from January to September 2016, with the last four months averaging \$338/mbf.

The increase in prices in 2016 appears to have been initially driven by much higher first quarter housing starts compared to 2015, which spiked lumber demand and caught lumber dealers off-guard. Prices are expected to fall in the fourth quarter before increasing again in the beginning of 2017.

Through 2015 the price of a 'typical' DNR log averaged \$521/mbf, falling from the \$591/mbf average in 2014. The average price for 2016 is slightly higher at \$531/mbf through October. The decline in 2015 was primarily due to the dramatic slowdown in demand from China and an ample regional supply of both logs and lumber. Log prices are expected to remain flat through 2016 and begin increasing in 2017 from increased lumber demand.

Timber Sales Volume. Given current timber sales plans—and absent a new sustainable harvest calculation—sales volumes are still pegged at 500 mmbf in FY17 and beyond. We have more confidence in the assumptions supporting the 500 mmbf in FY17 than we had in September.

Timber Sales Prices. External analysts expect flat stumpage prices through the remainder of 2016 and higher prices beginning in 2017. Prices for DNR sales in FY17 to-date have been weak compared to analyst expectations but higher than most auctions last year, averaging \$304/mbf for the first four auctions. Although these are on relatively low volume compared to total expected sales for the year, it is an indication that our current price forecast of \$360/mbf is likely too high, so we are reducing the FY17 forecast to \$350/mbf. We're lowering FYs 18 and 19 to \$363 (-6) and \$367 (-5), respectively.

Timber Removal Volume and Prices. Accounting for changes to purchaser plans and the timing of contract expirations, we're lowering FY 17 harvest volume expectations by 43 mmbf to 565 mmbf. In FYs 18-20, compensating increases of 13, 23, and 7 mmbf yield annual estimates of 604, 531, and 514 mmbf.

Timber removal prices for FY16 were \$339/mbf, slightly higher than expected in the June forecast. Timber removal prices are projected to be about \$303 (+\$2), \$348 (+\$6) and \$363 (-2) per mbf for FYs 17-19. These removal prices reflect changes in the removal timing and follow from, and lag behind, the changes projected in timber sales prices.

Timber Revenue. The above changes to timber sales prices, sales volumes, and harvest timing have shifted projected revenue down in FYs 17 and 21, but up in FYs 18, 19, and 20. Revenues for the 2015-2017 biennium are forecast to total \$337 million, down three percent (\$12 million) from September's forecast. Revenues for the 2017-2019 biennium will be up by four percent (\$15 million) to \$402 million.

Uplands and Aquatic Lands Lease (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.

Revenue estimates from non-timber uplands are virtually unchanged from the September Forecast.

Expected geoduck revenue for FY17 is increased by \$1 million due to a surprisingly high average price for the August auction and increases in sales volume assumptions. This increase outweighed a small decrease in expected earnings from water-dependent rents. In outlying years aquatics revenues are unchanged.

Total Revenues. Forecast revenues for the 2015-2017 Biennium (FYs 16 and 17) are lowered by \$11 million to \$476 million. Most of the revenue change is driven by expected timber prices and harvest timing. Revenues for the 2017-2019 Biennium (FYs 18 and 19) are increased by \$15 million to \$542 million.

Notes to the Forecast. 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. These issues may also affect sales volumes in outlying years, where the assumed sustainable harvest volume of 500 mmbf might prove too high.

A continuing downside risk for the forecast is timber and lumber demand from China. While it seems that a decrease in demand has largely been accounted for in the current market prices, and the export volumes of logs and lumber has largely stabilized, the Chinese economy continues to have issues. There is continuing concern that the slowdown in China could become dramatically worse.

In the November 2015 forecast, we noted that the expiration of the Softwood Lumber Agreement posed a major downside risk to the forecast because the expiration of tariffs might allow a flood of cheaper Canadian lumber into the US, suppressing domestic prices. Though the expiration of the SLA has likely held down prices, it has not resulted in the dramatic price drops that some feared. Current expectations are that the SLA situation will cause a counter-seasonal increase in prices this autumn, which will fall back until early in 2017.

Robust growth in U.S. housing demand would provide much needed, if unlikely, high-side potential. This has not yet eventuated, despite strong employment growth for the last two years. The lack of housing demand is likely due to a number of impediments—persistently stringent lending standards, a continued tough labor market for younger workers, student loan debt, and general economic and social malaise—most of which are lessening, but none of which show signs of completely abating just yet.

In late 2015, China once again instituted a ban on geoduck imports from the Pacific Northwest due to paralytic shellfish poison (PSP) and arsenic concerns. However, once again, this doesn't appear to have had an impact on prices or harvest activity. In late February, the Washington Department of Health posted an article saying that China had lifted the ban and it listed the areas cleared for ge-

duck export to China.

Additionally, on-going friction between geoduck purchasers and divers could disrupt the market, though these seem to have settled. As always in the geoduck fisheries, PSP closures create uncertainty around harvest volumes as well.

Table 1: November 2016 Forecast by Source (millions of dollars)

Timber Sales		FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21
Volume (mmbf)		497	473	545	500	500	500	500	500
	Change			-	-	-	-	-	-
	% Change			0%	0%	0%	0%	0%	0%
Price (\$/mbf)		356	348	285	350	363	362	340	340
	Change			\$ -	\$ (10)	\$ (6)	\$ (5)	\$ 0	\$ 0
	% Change			0%	-3%	-2%	-1%	0%	0%
Value of Timber Sales		177.2	164.5	155.3	175.0	181.6	181.0	170.0	170.0
	Change			\$ -	\$ (5.0)	\$ (2.9)	\$ (2.4)	\$ 0.0	\$ 0.0
	% Change			0%	-3%	-2%	-1%	0%	0%
Timber Removals									
Volume (mmbf)		471	449	490	565	604	531	514	500
	Change				\$ (43)	\$ 13	\$ 23	\$ 7	\$ -
	% Change			0%	-7%	2%	4%	1%	0%
Price (\$/mbf)		323	359	339	303	348	363	357	346
	Change			\$ -	\$ 2	\$ 6	\$ (2)	\$ (3)	\$ (1)
	% Change			0%	1%	2%	-1%	-1%	0%
Timber Revenue		152.1	161.4	166.3	171.1	210.0	192.4	183.6	172.8
	Change			\$ -	\$ (12)	\$ 8	\$ 7	\$ 1	\$ (1)
	% Change			0%	-6%	4%	4%	1%	0%
Upland Leases									
Irrigated Agriculture		6.7	7.8	8.7	7.9	7.9	7.9	7.9	7.9
	Change			\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
Orchard/Vineyard		9.4	8.3	8.2	7.6	7.4	7.4	7.4	7.4
	Change			\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
Dryland Ag/Grazing		7.4	5.0	5.2	6.0	6.6	6.6	6.6	6.6
	Change			\$ -	\$ (0)	\$ -	\$ -	\$ -	\$ -
	% Change			0%	-2%	0%	0%	0%	0%
Commercial		9.6	8.2	9.0	9.4	9.4	9.4	9.4	9.4
	Change			\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
Other Leases		8.8	9.4	9.9	9.8	9.7	10.0	10.2	10.3
	Change			\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
Total Upland Leases		41.9	38.6	41.0	40.7	41.1	41.4	41.5	41.7
	Change			\$ -	\$ (0)	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
Aquatic Lands									
Aquatic Leases		10.5	10.9	\$ 11	\$ 11	\$ 11	\$ 11	\$ 11	\$ 11
	Change			0%	-10%	0%	0%	0%	0%
	% Change			\$ -	\$ (0)	\$ -	\$ -	\$ -	\$ -
Geoduck		22.1	21.0	\$ 14	\$ 20	\$ 18	\$ 18	\$ 17	\$ 17
	Change			0%	98%	0%	0%	0%	0%
	% Change			\$ -	\$ 0	\$ -	\$ -	\$ -	\$ -
Aquatic Lands Revenue		32.7	31.9	25.6	30.8	28.3	28.7	27.4	27.2
	Change			\$ -	\$ 1	\$ -	\$ -	\$ -	\$ -
	% Change			0%	3%	0%	0%	0%	0%
Total All Sources		226.6	231.9	232.9	242.6	279.4	262.4	252.6	241.6
	Change			\$ -	\$ (11)	\$ 8	\$ 7	\$ 1	\$ (1)
	% Change			0%	-4%	3%	3%	1%	0%

Table 2: November 2016 Forecast by Fund (millions of dollars)

Management Funds		FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21
041	RMCA - Uplands	33.2	30.4	36.0	36.5	41.1	39.8	38.6	37.0
	Change			\$ -	\$ (2)	\$ 1	\$ 1	\$ 0	\$ (0)
	% Change			0%	-6%	2%	3%	1%	0%
041	RMCA - Aquatic Lands	14.8	14.4	11.3	13.8	12.5	12.7	12.1	12.0
	Change			\$ -	\$ 0	\$ -	\$ -	\$ -	\$ -
	% Change			0%	3%	0%	0%	0%	0%
014	FDA	19.6	23.2	22.8	22.9	26.9	25.1	24.0	22.6
	Change			\$ -	\$ (1)	\$ 1	\$ 1	\$ 0	\$ (0)
	% Change			0%	-3%	3%	4%	1%	0%
Total Management Funds		67.6	68.0	70.2	73.2	80.5	77.6	74.8	71.7
	Change			\$ -	\$ (3)	\$ 2	\$ 2	\$ 0	\$ (0)
	% Change			0%	-4%	2%	3%	0%	0%
Current Funds									
113	Common School Construction	56.6	50.4	59.7	56.6	74.5	70.3	68.8	66.2
	Change			\$ -	\$ (3)	\$ 3	\$ 1	\$ 0	\$ (0)
	% Change			0%	-5%	5%	2%	0%	0%
999	Forest Board Counties	52.0	64.8	55.3	61.2	68.6	62.0	58.9	55.5
	Change			\$ -	\$ (2)	\$ 3	\$ 3	\$ 0	\$ (0)
	% Change			0%	-3%	4%	4%	1%	0%
001	General Fund	2.2	1.8	4.1	2.3	3.6	3.9	3.8	3.6
	Change			\$ -	\$ (0)	\$ (0)	\$ 0	\$ 0	\$ (0)
	% Change			0%	-7%	-4%	3%	1%	0%
348	University Bond Retirement	1.8	2.8	1.8	2.7	3.3	2.2	2.1	1.9
	Change			\$ -	\$ 0	\$ 0	\$ 0	\$ 0	\$ (0)
	% Change			0%	21%	8%	7%	1%	0%
347	WSU Bond Retirement	1.7	1.8	1.4	1.7	1.8	1.8	1.9	1.9
	Change			\$ -	\$ (0)	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
042	CEP&RI	5.5	5.2	3.1	4.3	4.3	4.7	4.5	4.3
	Change			\$ -	\$ (0)	\$ (1)	\$ 0	\$ 0	\$ (0)
	% Change			0%	-5%	-12%	4%	1%	0%
036	Capitol Building Construction	6.7	4.9	6.7	8.1	9.6	9.2	8.7	8.2
	Change			\$ -	\$ (1)	\$ (1)	\$ 0	\$ 0	\$ (0)
	% Change			0%	-11%	-6%	4%	1%	0%
061/3/5/6	Normal (CWU, EWU, WWU, TESC) School	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2
	Change			\$ -	\$ (0)	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
Other Funds		1.5	0.5	0.1	0.7	1.1	0.2	0.2	0.1
	Change			\$ -	\$ 0	\$ 1	\$ 0	\$ 0	\$ (0)
	% Change			0%	19%	+500%	16%	1%	0%
Total Current Funds		128.1	132.4	132.2	138.0	166.9	154.5	149.0	142.1
	Change			\$ -	\$ (6)	\$ 6	\$ 5	\$ 1	\$ (0)
	% Change			0%	-4%	4%	3%	1%	0%

(Continued)

Table 3: November 2016 Forecast by Fund (millions of dollars), cont'd

Aquatic Lands Enhancement Account		FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21
02R		17.9	17.4	14.2	17.0	15.7	15.9	15.3	15.2
	Change			\$ -	\$ 0	\$ -	\$ -	\$ -	\$ -
	% Change			0%	3%	0%	0%	0%	0%
Permanent Funds									
601	Agricultural College Permanent	3.5	4.1	7.6	5.9	5.4	4.5	4.1	3.9
	Change			\$ -	\$ (1)	\$ 0	\$ 0	\$ 0	\$ (0)
	% Change			0%	-18%	2%	6%	1%	0%
604	Normal School Permanent	1.8	1.7	2.4	2.8	3.9	3.2	3.0	2.8
	Change			\$ -	\$ (1)	\$ 0	\$ 0	\$ 0	\$ (0)
	% Change			0%	-17%	10%	5%	1%	0%
605	Common School Permanent	0.4	0.7	1.0	0.3	0.3	0.3	0.3	0.3
	Change			\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
	% Change			0%	0%	0%	0%	0%	0%
606	Scientific Permanent	6.1	7.1	5.0	5.2	6.3	5.8	5.4	5.1
	Change			\$ -	\$ (1)	\$ (0)	\$ 0	\$ 0	\$ (0)
	% Change			0%	-13%	0%	5%	1%	0%
607	University Permanent	1.1	0.4	0.2	0.2	0.3	0.6	0.6	0.5
	Change			\$ -	\$ (0)	\$ (0)	\$ (0)	\$ 0	\$ (0)
	% Change			0%	-61%	-34%	0%	1%	0%
Total Permanent Funds		13.0	14.0	16.2	14.4	16.2	14.4	13.4	12.7
	Change			\$ -	\$ (3)	\$ 0	\$ 1	\$ 0	\$ (0)
	% Change			0%	-17%	2%	5%	1%	0%
Total All Funds									
		FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21
		226.6	231.9	232.9	242.6	279.4	262.4	252.6	241.6
	Change				\$ (11)	\$ 8	\$ 7	\$ 1	\$ (1)
	% Change				-4%	3%	3%	1%	0%

Figure 1: Timber Forecast Charts

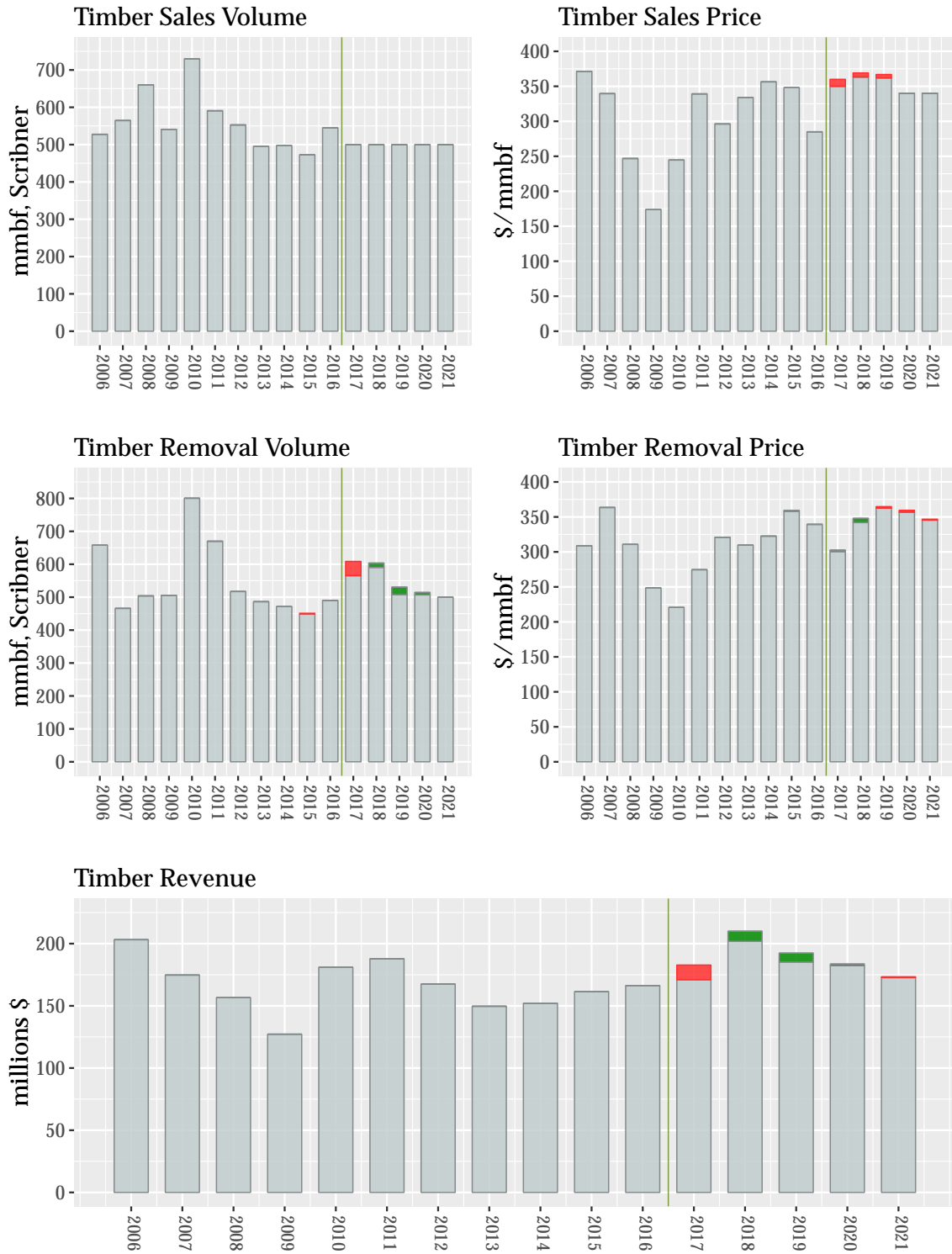


Figure 2: Other Uplands Forecast Charts

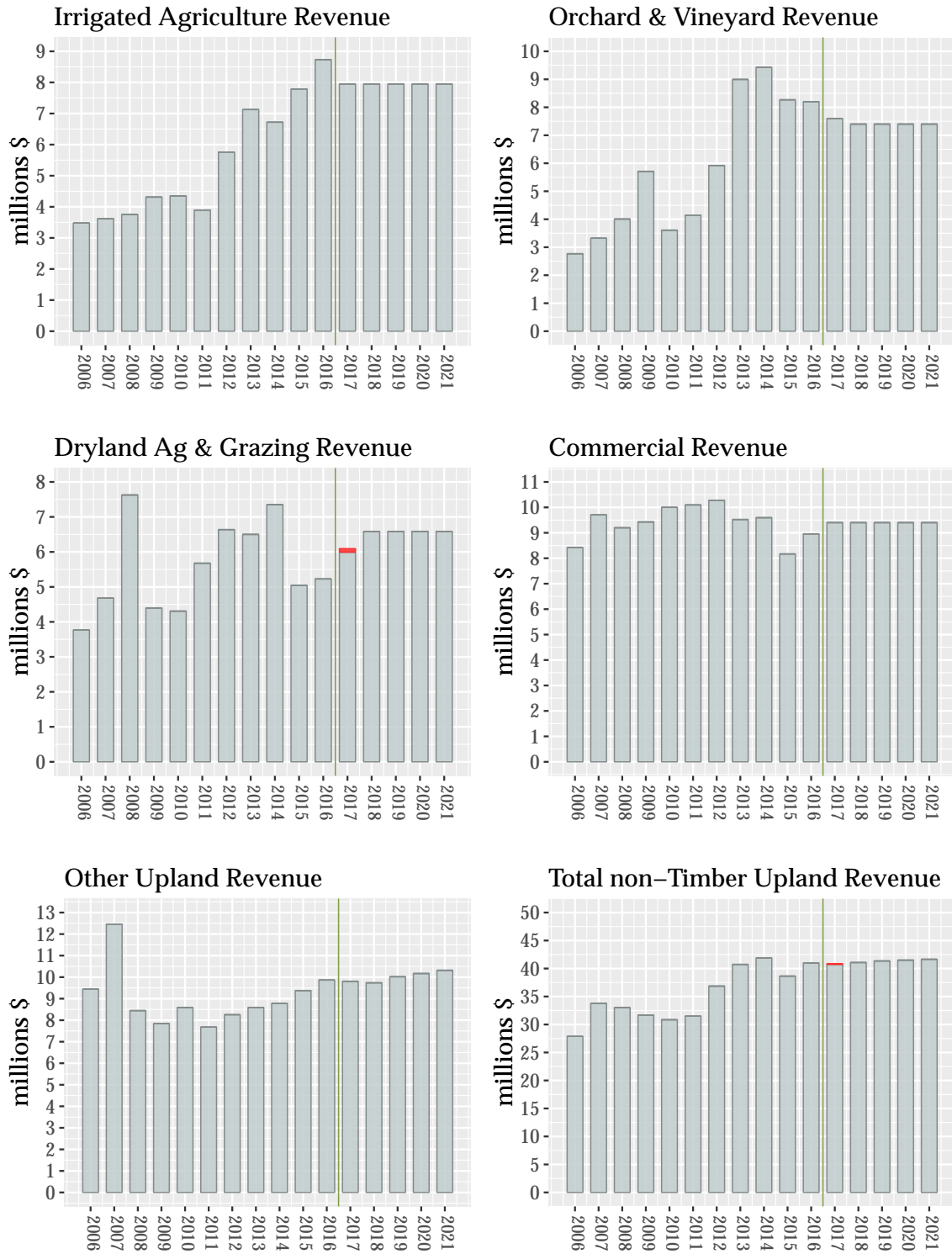
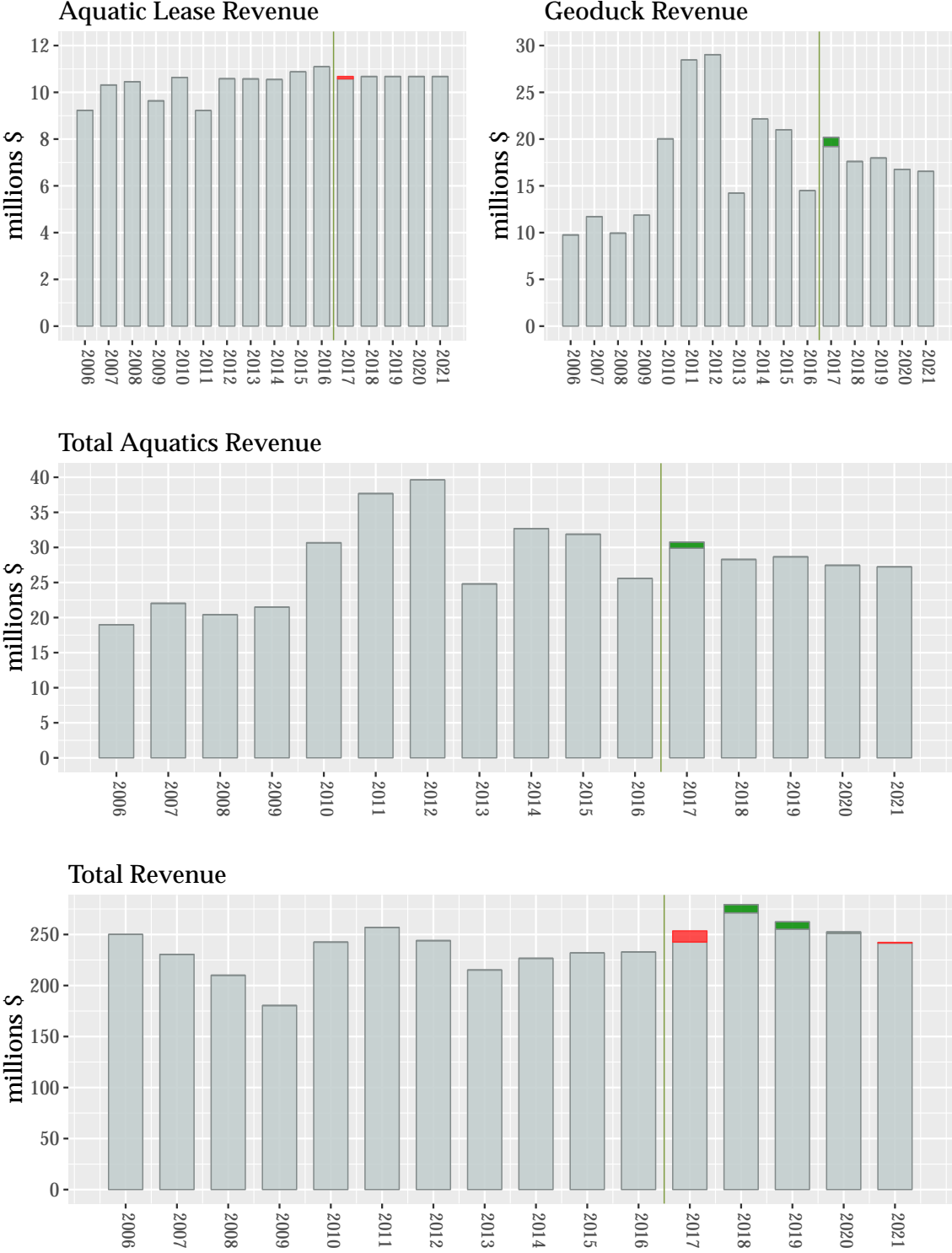


Figure 3: Aquatics and Total Forecast Charts



Contents

Forecast Summary	I
Macroeconomic Conditions	1
U.S. Economy	1
Gross Domestic Product	1
Employment and Wages	1
Inflation	3
Interest Rates	4
The U.S. Dollar and Foreign Trade	4
Petroleum	5
World Economy	5
Europe	5
China	6
Japan	6
Wood Markets	7
U.S. Housing Market	8
Existing Home Sales	8
New Home Sales	9
Household Formation	9
Housing Starts	10
Housing Prices	10
Housing Affordability	11
Export Markets	12
Timber Supply	12
Price Outlook	13
Lumber Prices	13
Log Prices	13
Stumpage Prices	14
DNR Stumpage Price Outlook	14
DNR Revenue Forecast	16
Timber Revenue	16
Timber Sales Volume	16
Timber Removal Volume	16
Timber Sales Prices	17
Timber Removal Prices	17
Timber Removal Revenue	17
Upland Lease Revenues	19
Aquatic Lands Revenues	20
Total Revenues from All Sources	21
Some Caveats	21
Distribution of Revenues	22

List of Tables

1	November 2016 Forecast by Source (millions of dollars)	III
2	November 2016 Forecast by Fund (millions of dollars)	IV
3	November 2016 Forecast by Fund (millions of dollars), cont'd	V

List of Figures

1	Timber Forecast Charts	VI
2	Other Uplands Forecast Charts	VII
3	Aquatics and Total Forecast Charts	VIII
4	U.S. Gross Domestic Product	1
5	Unemployment Rate and Monthly Change in Jobs	2
6	Employment and Unemployment	2
7	Labor Market Indicators	3
8	U.S. Inflation Indices	3
9	Trade-Weighted U.S. Dollar Index	4
10	Crude Oil Prices	5
11	Lumber, Log and Stumpage Prices in Washington	7
12	Lumber, Log, and DNR Stumpage Price Seasonality	7
13	Home Sales and Starts as a Percentage of Pre-Recession Peak	8
14	Existing Home Sales	8
15	New Single-Family Home Sales	9
16	Housing Starts	10
17	Case-Shiller Existing Home Price Index	11
18	Housing Affordability	11
19	Log Export Prices	12
20	Log Export Volume	12
21	DNR Composite Log Prices	14
22	DNR Timber Stumpage Price	15
23	Forecast Timber Sales Volume	16
24	Forecast Timber Removal Volume	16
25	Forecast Timber Sales Price	17
26	Forecast Timber Removal Price	17
27	Forecast Timber Removal Value	18
28	Forecast Timber Removal Revenue	18
29	Forecast Upland Lease Revenue	19
30	Aquatic Lands Revenues	20
31	Geoduck Auction Prices	20
32	Total Revenues	21

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
mbf	Thousand board feet
mmbf	Million board feet
PPI	Producer Price Index
Q1	First quarter of year (similarly, Q2, Q3, and Q4)
QE	Quantitative Easing
RCW	Revised Code of Washington
RISI	Resource Information Systems, Inc.
RMCA	Resource Management Cost Account
SA	Seasonally Adjusted
SAAR	Seasonally Adjusted Annual Rate
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. Each re-evaluates world and national macroeconomic conditions, and the demand and supply for forest products and other goods. Finally, each 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 determined 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 2017 through 2021. Fiscal years for Washington State government begin July 1 and end June 30. For example, the current fiscal year, Fiscal Year 2017, runs from July 1, 2016 through June 30, 2017.

The baseline date (the point that designates the transition from "actuals" to predictions) for DNR revenues in this Forecast is October 1st, 2016. 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 October 2016. 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)
November 2016	October 1, 2016	November 15, 2016
February 2017	January 1, 2017	February 15, 2017
June 2017	May 1, 2017	June 15, 2017
September 2017	August 1, 2017	September 15, 2017

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.

Special thanks are due to those in the wood products industry who provided information for DNR's survey of timber purchasers. These busy individuals and companies volunteered information essential to forecasting the timing of timber removal volumes, a critical component of projecting DNR's revenues on behalf of beneficiaries.

Thanks also go to DNR staff who contributed to the Forecast. Tom Shay, Andrew Hayes, Rick Roeder, Katy Mink, Tom Heller, Patrick Ferguson, Kristin Swendall, Blain Reeves, and Linda Farr provided data and counsel, including information on markets and revenue flows in their areas of responsibility.

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

DNR Office of Budget and Economics

David Chertudi, Lead Economist
Kristoffer Larson, Economist

Macroeconomic Conditions

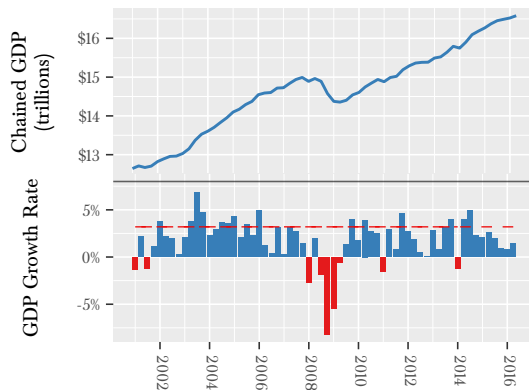
This section briefly reviews macroeconomic conditions in the United States and world economies because they influence DNR revenue—most notably through the bid prices for DNR timber sales and lease revenues from managed lands.

U.S. Economy

Gross Domestic Product

Since the end of the Great Recession in 2008 and 2009, when GDP declined in five out of six quarters, GDP growth has 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 year 2014 was widely predicted to be the year that broke the pattern of stagnation, but annual growth was held down to 2.4 percent because a harsh winter and business inventory adjustments caused GDP to contract in the first quarter. The year 2015 was also widely predicted to be the year

that broke the pattern, with a continuation of the strong employment growth from 2014 finally causing an increase in consumption and investment. However, a similar pattern to 2014 emerged and GDP growth over 2015 was the same as 2014, 2.4 percent.

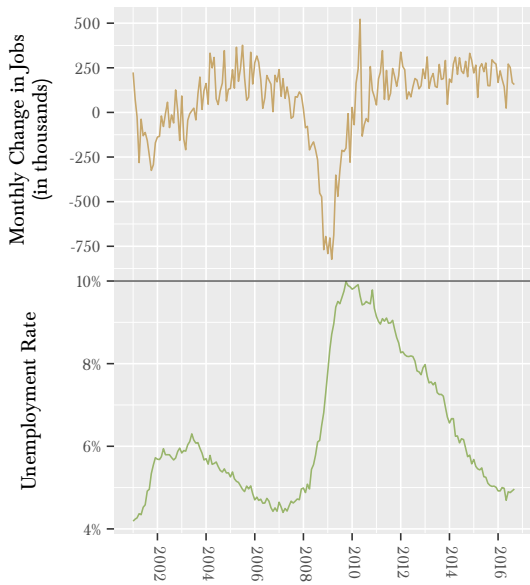
The pattern of reduced expectations in 2014 and 2015 has continued in 2016, with analysts dropping forecasts from around 3.0 percent to around 2.5 percent at the beginning of the year after disappointing fourth quarter 2015 growth, then further to below 2.0 percent as first quarter growth disappointed. The Federal Open Market Committee (FOMC) forecasts were also decreased in March 2016 and again in June, when the median GDP growth rate prediction decreased from 2.4 to 2.0 percent and the range moved from 2.0-2.7 to 1.8-2.2.

Employment and Wages

The U.S. headline unemployment rate declined through 2015 from 5.7 percent in January 2015 to 4.9 percent in January 2016 (Figure 5). Since January the unemployment rate hovered between 4.9 and 5.0 percent, except when it dipped to 4.7 percent in May. This is well down from a high of 10.0 percent in October 2009 and is below the average unemployment rate of 5.2 percent from 2001-2006. In general, analysts expect the unemployment rate to remain in this range for the next couple of years. The FOMC projections remain at a median of 4.7 percent unemployment for 2016, with estimates ranging from 4.3 to 4.8 percent.

Average job growth for 2016 through September was 178,000 jobs created per month, compared to 211,000 over the same period last year. Strong job growth in June and July, averaging 262,000 per month, pulled up the year-to-date average from the 150,000 jobs per month reported in the June forecast. However, August and September job growth disappointed with only 167,000 and 156,000, respectively. This is all generally in line with analyst expectations of somewhat slower job growth in 2016.

Figure 5: Unemployment Rate and Monthly Change in Jobs

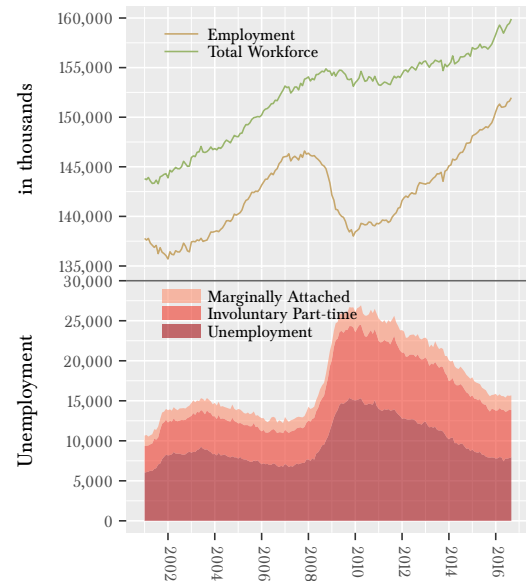


The unemployment rate is a useful indicator to track because it gives insight into slack in the labor market; that is, how many people are available to work before job growth starts driving problematic inflation. The labor market is the driving force behind consumption, which constitutes about 70 percent of GDP and naturally extends to the demand for housing, which is the major driver of timber demand in the U.S. Data and anecdotes abound that show 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 take on housemates.

Although the unemployment rate continues to decline, it has not yet translated into strong wage growth, which is likely a prerequisite for broader improvement in the economy and an increase in the demand for housing. 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, since the recession the labor force participation rate has declined significantly, possibly because workers left the labor force after they were unable to find jobs.

Figure 6: Employment and Unemployment

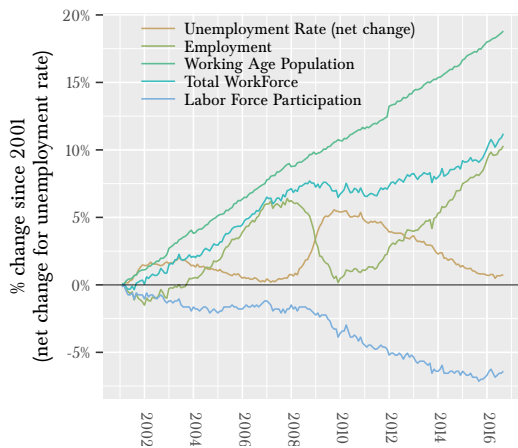


An alternative measure of unemployment is the U-6 unemployment rate, which includes involuntarily part-time employment and marginally attached workers, who are not included in the headline unemployment rate but who, nevertheless, are likely to be looking for work and would benefit from better job prospects. The U-6 has declined from a high of 17.1 percent in 2010 to 11.3 percent in January 2015. The U-6 continued to decline through February 2016, but has remained at roughly 9.7 percent since then. It remains higher 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.

Reductions in the labor force participation rate have helped move the unemployment rate and the U-6 lower (Figure 7). 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 look 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 and as it decreases wages will be pushed up as companies compete for labor.

Figure 7: Labor Market Indicators



The drop in the participation rate since 2008 suggests that something about the recession itself caused people to leave the labor market, and implies that they may return when things are looking a bit better. However, Federal Reserve analysts have suggested that the recent 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.

BLS data show that in August, out of the 92 million people not in the labor force, around four million people want a job and are not included in the headline rate or U-6. Given that there are almost eight

million people counted as unemployed, four million additional potential workers (who haven't applied for work in the last year, but want a job) might add meaningful slack to labor supply.

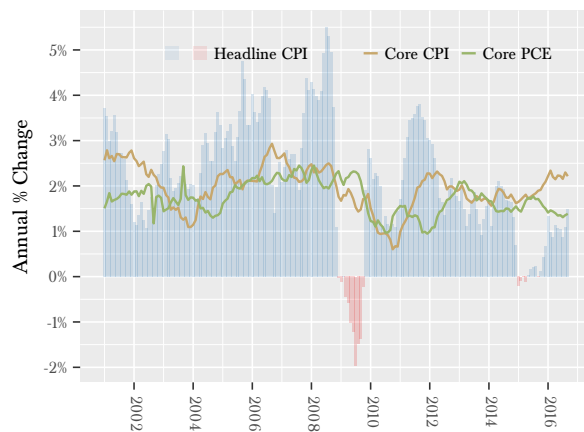
Inflation

The FOMC's inflation outlook for 2015 deteriorated significantly through 2015 from a predicted range of 1.0-2.2 percent in December 2014 meeting, to a final average of 0.7 percent for the year. From the December 2015 meeting to the May 2016 meeting the FOMC's projected inflation for 2016 has also dropped, falling from 1.2-2.1 to 1.0-1.6. However, the FOMC's inflation expectations grew at the June meeting, increasing to a range of 1.3-2.0. (Figure 8).

For policy purposes, the FOMC uses the core (PCE) index as the guiding measure of inflation, which removes the more volatile fuel and food prices. This measure shows long-term inflation at or below the two percent target since September 2008. The FOMC slightly reduced its predicted range of the core PCE for 2016 to 1.3-2.0 percent in the June Economic Projections.

The consensus among forecasters, including the FOMC, is that core inflation will remain at or below two percent through 2018.

Figure 8: U.S. Inflation Indices

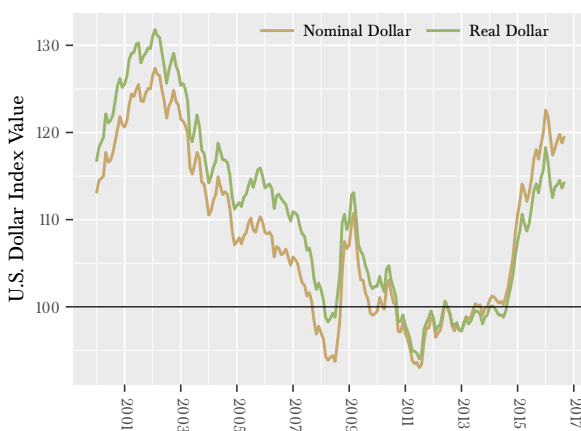


Interest Rates

Seldom in U.S. history has it been so inexpensive to borrow money. 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 two percent inflation.

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 interests rates from their historic lows. This was widely expected because the FOMC had been carefully preparing markets for it with each successive meeting statement. However, it was not an uncontentious decision.

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



Pressure had been building to increase interest rates since mid-2014. Arguments for raising interest rates revolve around the steady increase in employment and the need to avoid sharp increases in inflation, and the need for the Fed to maintain the confidence of markets. Arguments for resisting the increase in rates are manifold. They generally note that sharp increases in inflation are not a danger from any reasonable economic model, that inflation somewhat

above the target rate is not a disaster and easily addressed when it happens, that the inflation target itself is too low, and that raising rates too quickly could further undermine the weak recovery we have experienced.

The question of whether to raise interest rates is important because it is the key tool of monetary policy. An increase in interest rates will 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.

From the December 2015 rate rise, the FOMC was indicating 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, in March this was revised to 0.9 percent for 2016, suggesting only two rate increases. In June, the expected median funds rate remained at 0.9 percent; however, the FOMC did not raise rates at that meeting, suggesting rate rises coming in both September and December. Given continued weakness in core inflation, the seeming stabilization of the unemployment rate around 4.9-5.0 percent, and the poor jobs growth from August it is unclear whether the FOMC will stay with the current plan or hold off until employment growth starts showing a definite effect on inflation.

The U.S. Dollar and Foreign Trade

The trade-weighted U.S. dollar index has climbed dramatically and although it has decreased since January, it is still around 15 percent higher than it was in mid-2014. (Figure 9).

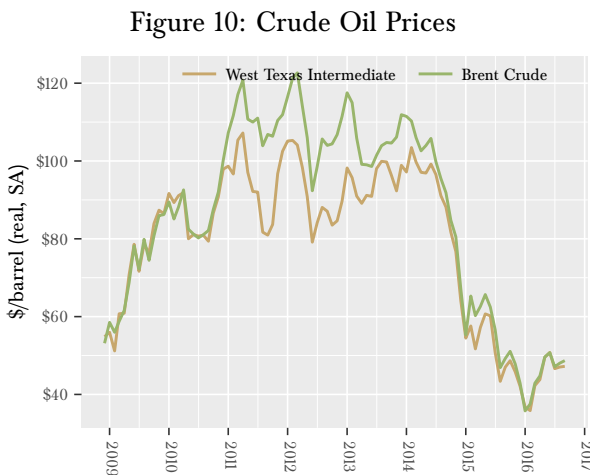
Importantly, a rising dollar means that timber and lumber from the Pacific Northwest become more expensive for international buyers and imported timber and lumber become less expensive. This will tend to suppress local prices and DNR's timber and

agricultural revenues. Wildstock geoduck revenue will also be negatively affected because geoduck is primarily marketed abroad.

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 have plummeted from \$108/barrel in January 2014 to \$30/barrel in January 2016, a 70 percent drop. Since January, prices have increased to \$45/barrel.

Broadly, a drop in oil prices acts like a tax cut for consumers and can encourage consumption. However, data suggest that households are saving the windfall or paying down debt instead of spending it. Additionally, the drop has been sudden and severe enough that it has undermined business investment in oil production, which has created another drag on economic growth.



All other things being equal, this drop in petroleum prices has lowered 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 risen dramatically and will make PNW timber more

expensive internationally. These two forces are opposing and it is unclear which will be more influential on PNW natural resource exports.

World Economy

Europe

Forecasts for the U.S. economy often cite Europe's ongoing financial crisis and very weak economic performance as a significant downside risk. The EU (28 countries) is the fourth largest trading partner of the U.S. and, as a whole, was hammered by the Great Recession, collectively suffering a 4.5 percent contraction in 2009. This was followed by two years of slow growth, and another year of contraction. After no growth in 2013, 2014 saw real EU GDP growth of 1.3 percent—finally surpassing 2007's GDP in real terms.

After several dramatic months as the primary concern of the European economy, a deal was reached in July 2015 between Greece and its eurozone creditors that averted (at least temporarily) a Greek default or exit from the euro. However, in June the UK held a referendum to exit the European Union. Markets have calmed down after the initial turmoil, but an eventual exit would almost certainly have adverse economic effects on both the UK and the EU. It is not clear that the UK will actually leave the union. The UK government has not yet triggered Article 50 of the Lisbon Treaty, which would initiate the process of leaving the EU, there is significant political resistance to leaving, and the negotiations to leave would be extremely complex. However, even if the UK does not leave, these uncertainties will likely undermine investment and growth for some time.

Other issues with the European economy include persistent low inflation, though the risk of a deflationary spiral appears to have abated, and an unemployment rate that remains above 10 percent, though it varies widely between countries.

Weakness in Eurozone economies means reduced demand for U.S. exports, but it has thus far been difficult to identify specific tangible effects on the

U.S. economy.

China

China is a major export market for logs and lumber 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 a major 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 of the past eight years better than most other economies. However, that resilience is proving 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. Already, Chinese GDP growth has slowed from 10.4 percent in 2010 to 6.9 percent in 2015. The IMF forecasts a further decline to 6.3 percent in 2016.

There is growing concern that the IMF forecasts are overly optimistic and that Chinese GDP growth will fall much lower, possibly even into recession. 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) has 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.

Analysts seem to broadly agree that in order to continue growing and to stabilize its economy China needs to pivot from its heavy reliance on investment toward a broader consumption basis. In order to do this it would need to encourage domestic spending

and move away from saving, but the political measures that are needed to do this are impeded by entrenched interests.

Japan

Japan is another major export market for the Pacific Northwest—importing around 35 percent of the softwood logs exported from the Seattle and Columbia River customs districts since 2012. Unfortunately, Japan's growth has stagnated since the early 1990s after a stock market and property bubble bust trapped the economy into a deflationary spiral. After his election in late 2012, Japanese Prime Minister Shinzo Abe began a fairly bold combination of economic policy moves, dubbed 'Abenomics', in an attempt to revitalize Japan's economy.

These policies were initially well received by the Japanese, judging by increasing consumer confidence and GDP growth. However, GDP in 2014 actually shrank by 0.03 percent and grew by only 0.47 percent in 2015. The IMF expects weak growth of around 0.7 percent in 2016.

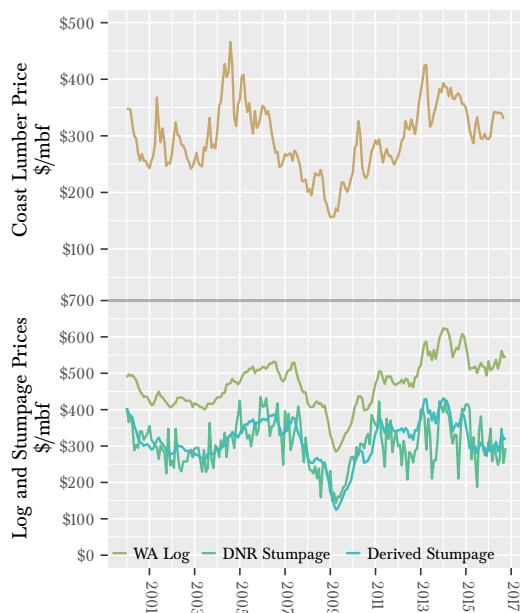
In 2014, Japanese CPI grew by 2.7 percent, suggesting they may have escaped their deflationary spiral. However, CPI growth in 2015 was held back by falling energy and food prices and grew by only 0.8 percent. More recently, the Japanese government has delayed implementing an increase in the consumption tax after the CPI fell in both March and April, although the core inflation (inflation less food and oil) was still positive at 0.90 percent year-on-year to April.

The Bank of Japan implemented negative interest rates in late January to augment their quantitative easing activities, which would ideally spur spending and force inflation and GDP higher. However, this hasn't been effective enough. Inflation since June has been negative (that is, deflationary) and GDP growth for the second quarter was only 0.8 percent. This has increased pressure on the Bank of Japan to take some further action.

Wood Markets

Over the past decade, timber stumpage revenue has constituted over 75 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 revenues generated by DNR.

Figure 11: Lumber, Log and Stumpage Prices in Washington

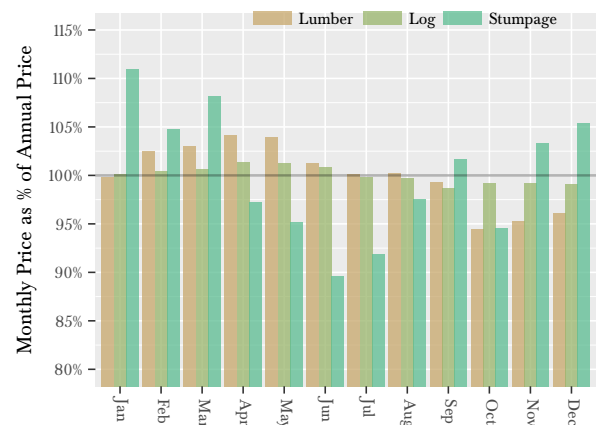


In general, timber stumpage prices reflect demand for lumber and other wood products, timber supply, and regional lumber mill capacity. There is a consistent, positive relationship between log prices and DNR's stumpage prices, despite notable volatility in stumpage prices (Figure 11). High log prices make access to logs more valuable and increase purchasers' willingness to pay for stumpage (the right to harvest). Volatility in stumpage prices arises 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 do not often 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

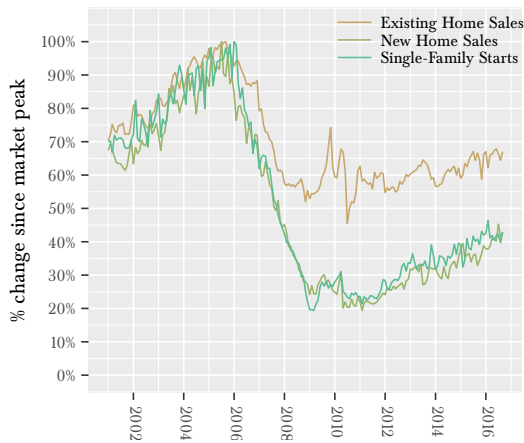
mix, which varies throughout the year but tends to be worse from July through September.

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.

Figure 13: Home Sales and Starts as a Percentage of Pre-Recession Peak



The crash in the housing market and the following recession drastically reduced demand for new housing, which undermined the total demand for lumber (Figure 13). Since the trough from 2009-11, 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.

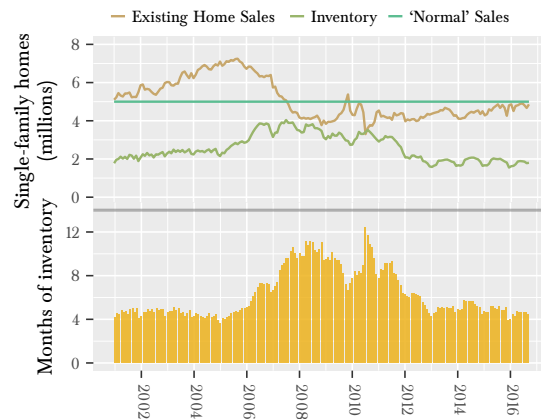
Housing demand has remained broadly subdued due to tight lending standards, weak labor markets,

and increasing prices at the same time as stagnant or declining real wages for much of the population. However, lending standards have relaxed a little and the labor market is tightening, but these improvements are happening very slowly. A number of measures suggest that the modest recovery in housing demand has resumed after stalling through late 2014.

Existing Home Sales

Existing home sales plummeted during the recession from around 6.5 million (SAAR) in 2006 to a low of around 4.1 million in 2012. They rose to average 4.6 million (SAAR) in 2015, an increase on the 4.3 million average of 2014 (Figure 14). There were about 4.8 million sales (SAAR) through September 2016.

Figure 14: Existing Home Sales



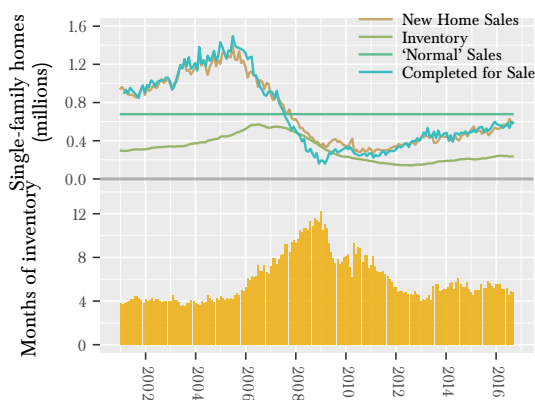
Changes in inventory can be a useful signal about the current relationship between supply and demand. A decreasing inventory suggests that demand is outstripping supply, which should put upward pressure on prices and encourage more homes to be listed or built. Single-family inventory has ranged between 1.6 and 2.2 million homes, with clear seasonal influences. Inventories have been building since the beginning of 2016 and currently stand at 1.8 million, which is right around historic norms.

After house prices fell in the recession, private investors moved into depressed housing markets and purchased large numbers of low-priced foreclosed residential properties. These investors have helped drive demand and may have set a floor under several key urban housing markets. There has been some concern among analysts about the potential impact on house prices if investors were to begin selling en-masse, thereby increasing the housing supply while demand continues to be weak. However, without significant potential returns from other investment, there seems little chance of a mass sell-off.

New Home Sales

Unsurprisingly, new home sales also plummeted during the recession, reaching a record low of 306,000 (SAAR) in 2011 before beginning a slow rise (Figure 15). New home sales have increased from 440,000 (SAAR) in 2014 to an average of 502,000 in 2015. The monthly sales for the first nine months of 2016 have averaged 564,000, an improvement compared to 2015 (which averaged 500,000 over the same period), but still well below the long-term (1963-2010) ‘normal’ rate of 678,000 sales per year.

Figure 15: 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, the inventory of new homes has crept up as construction slightly outpaced sales. However, construction too is still well below ‘normal’ levels.

Household Formation

Household formation (the growth in the number of households) is a key component of housing demand and a major driver of U.S. housing starts. Due to the job and income losses and to the greater financial precarity that the recession created, household formation fell as people shared housing and many younger people, who were hit especially hard, moved back in with their parents. Net immigration from Mexico also approached zero following the recession, and may have actually been negative, contributing to slowing household formation.

The drop in household formation and the consequent reduction in demand for home purchases contributed to the surge in the inventory of available housing units and significant drop in housing starts. Historically, U.S. household formation has ranged between 1.2 and 1.3 million per year; following the recession, household formations dropped dramatically to average 0.7 million per year from 2009-2014.

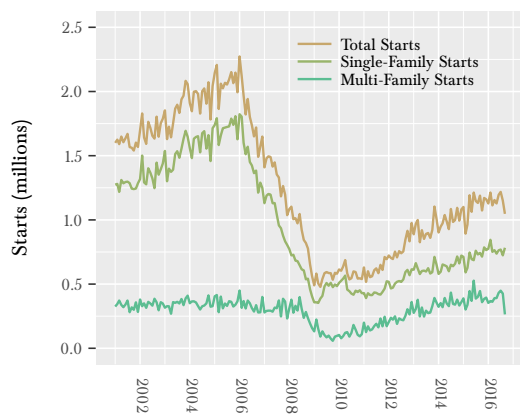
An important concept frequently discussed in relation to household formation is that of ‘pent-up’ demand—the demand for housing from those who wish to form households, but are currently unable to because of employment, earnings, or credit eligibility issues. Much of the discussion from analysts in the past several years has been about a large, and growing, pent-up demand as more young adults want to move out and create their own households. Analysts have consistently overestimated its impact on the housing market, repeatedly predicting a strong rebound in household formation and housing starts that has yet to emerge. In other words, pent-up demand has so far failed to become real demand, largely because of issues with employment, wages, credit requirements, and affordability.

Estimates suggest that there were between 1.3 and 1.5 million formations in 2015, which is in line with historical averages. However, preliminary data indicate a sharp slow-down in formations in the first half of 2016. Looking forward, household formation will depend on both the continued recovery in the U.S. labor market—more than just job growth, but also real wage growth—and improvements in housing affordability and mortgage access.

Housing Starts

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 16). In April 2009, U.S. housing starts fell to record lows since the Census Bureau began tracking these data in 1959.

Figure 16: 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 the first nine months of 2016, multi-family starts were lower than in the same period of 2015,

while single family starts increased from an average of 699,000 to 768,000 (SAAR).

Starts totaled around 1.0 million and 1.1 million (SAAR) in 2014 and 2015, overcoming low first quarter starts that were dragged down by severe weather in both years. The outlook for 2016 housing starts is about 1.2 million starts, which is what the average has been for the first nine months of the year. Continued improvements in household formations will increase demand, though it is unclear how long it will take before formations increase. Additionally, a recovery in house prices should facilitate the ‘move-up’ market. Combined with low market and shadow inventories constraining the supply of existing housing, prices should start increasing and provide incentives to build more houses; again, this is likely to be constrained by how much people are able to pay, so wages and lending standards will play a significant role.

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

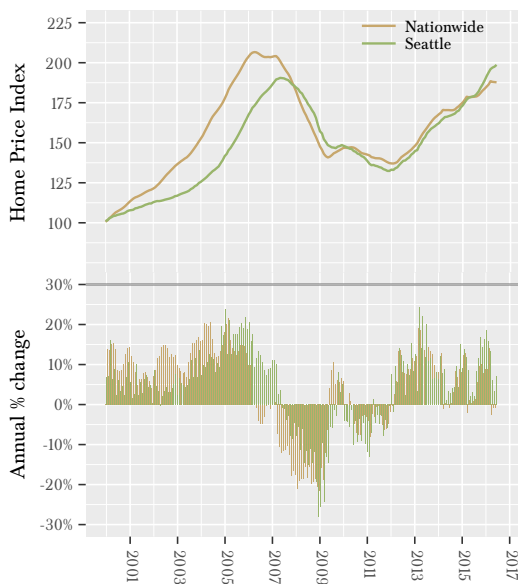
U.S. housing experienced six unprecedented years of falling or flat prices following the recession. House prices started rising again only in 2012 as economic and employment indicators continued to improve. Figure 17 charts the seasonally adjusted S&P/Case-Shiller Home Price Index for the 20-city composite, 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, almost ten years earlier.

Seattle house prices are growing much faster than national prices, increasing 10.4 percent year-on-year as of September, compared with 4.7 percent nationally. When Seattle prices bottomed in Febru-

ary 2012—their lowest point since June 2004—the average existing house in Seattle was worth only 70 percent of the May 2007 peak. As of September, the average Seattle home was worth five percent more than its peak price (in nominal terms).

The increase in prices is bringing back more normal foreclosure conditions in which homeowners can make rational decisions about whether to sell—as opposed to being forced to sell or to remain ‘underwater’ to avoid selling at a loss or compromising their credit. However, house prices elsewhere in the U.S.—especially in those areas most devastated by the foreclosure crisis—have not increased as heartily as in Seattle.

Figure 17: Case-Shiller Existing Home Price Index



Housing Affordability

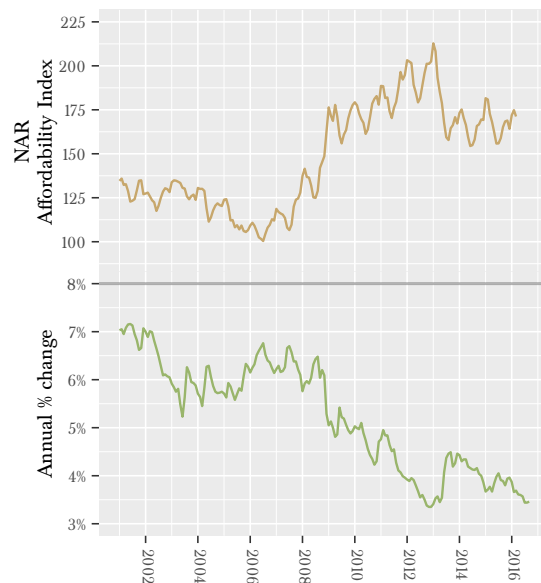
The National Association of Realtors’ (NAR) U.S. Housing Affordability Index is a useful, though imperfect, measure of how affordable or attainable houses are to the average American. Index values increase as affordability increases, and decline as homes become less affordable.

The affordability index is based on house prices,

mortgage rates and income. The index increases if house prices decrease, mortgage rates decrease or incomes increase. The index is useful because movements in house prices, mortgage rates and household income can offset each other so that it might not be immediately obvious how those changes affect their overall house buying power of the average household. The index provides an easy way to assess whether houses are more or less affordable on average. For instance, suppose incomes increase (which will generally increase affordability and put upward pressure on the index) but that mortgage rates also increase (which would put downward pressure on the index) — without the index it might be difficult to guess which one of these changes has a greater effect on affordability.

The affordability index peaked at a record high of 213 in January 2013 and then crashed to 158 in August of that year—its steepest decline in 30 years—on the back of increased interest rates and house prices (Figure 18). Following that decline the index rose and fell largely because of seasonal house price changes. Since August 2013, the index has been between 153 and 180. In August the index was 163.

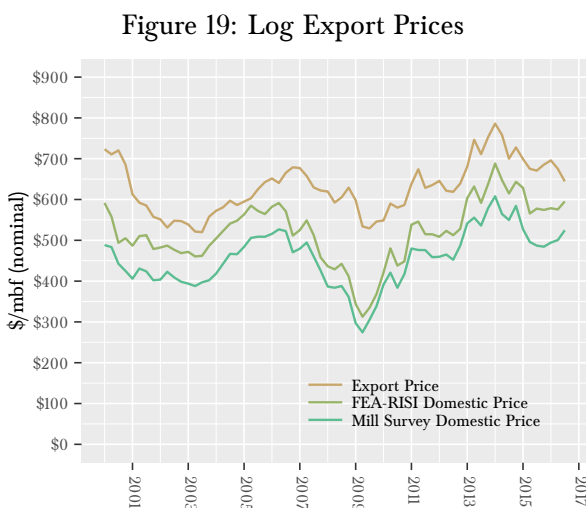
Figure 18: Housing Affordability



Export Markets

Although Federal law forbids 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 19). 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.



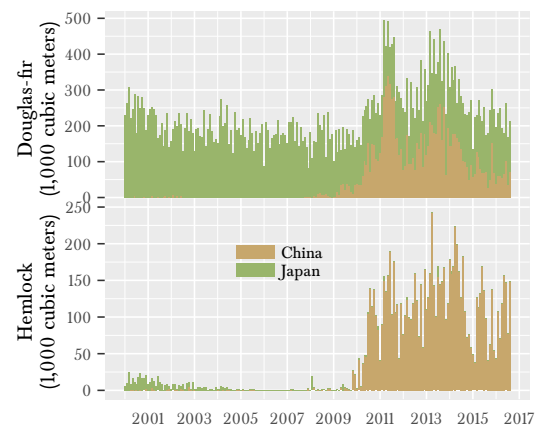
Note that the export prices shown in Figure 19 are weighted by DNR’s typical species mix, not the species mix of actual export volumes.

Since 2010, demand from China has been a major support for log and lumber prices in Washington. That demand waned significantly 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 the Russian tariff on log exports was re-

duced. 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 20). To June, 2016’s exports to China from the Seattle and Columbia-Snake River Customs Districts for both Douglas-fir and Hemlock are 172,000 m³, compared to 189,000 m³ in 2015 and 343,000 m³ in 2014.

The export premium is expected to shrink 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 yet more 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 and transportation constraints from the southeastern U.S.

Figure 20: Log Export Volume



Timber Supply

Since the beginning of the recession, timber growth has generally exceeded timber harvest, thereby increasing the timber inventory, throughout the U.S. However, strong log exports from the West Coast pushed up harvests relative to other parts of the country, such that now there is less timber inventory to draw on than in, say, the U.S. South. Timber growth is expected to continue to exceed harvest

through 2017, further increasing inventories. This suggests that the supply of timber in the U.S. will not be constrained by the availability of trees to harvest. However, analysts argue that the relatively ready availability of timber is unlikely to put significant downward pressure on prices because not all of the timber will enter the market at once and an expected increase in demand for timber, via an improving housing market, will offset the higher supply.

In Canada, 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. This damage increased British Columbia's harvested timber supply since 2007: typically, timber killed by beetles must be harvested within 4 to 10 years, so the government increased the allowable harvest to ensure that the dead timber was not wasted. These elevated timber supplies are already declining and it's expected that most of the beetle kill will be unviable by 2017. 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. Random Lengths' Coast Dry Random and Stud composite lumber price peaked at \$393/mbf in January 2014, but fell throughout the rest of the year to average \$373/mbf. This was largely due to a bitterly cold winter across much of the U.S. weakening 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 \$311/mbf.

Prices in the first nine months of 2016 have fared somewhat better, starting the year at \$294/mbf to climb to \$342/mbf in April, where it has basically

stayed, resulting in an average price of \$328/mbf thus far.

Prices were expected to pull back in the third quarter, but as of September this had not happened. Prices are now expected to spike in the Spring due to a potential trade dispute with Canada as a result of the expiration of the Softwood Lumber Agreement (SLA). The SLA expired in October 2015; however, because of the agreement, the U.S. has been prevented from bringing any trade action against Canada until 12 October, 2016. It is almost certain that U.S. lumber industry organizations will lodge a trade dispute with the U.S. International Trade Commission. Many market participants are aware of the potential action, but there is apparently a misconception that the trade action will immediately affect supply, thus the expectation of a spike in prices in November. Any duties imposed on Canadian lumber are unlikely to become effective until sometime in the first half of 2017. Until then, prices are expected to fall in the fourth quarter before increasing again in the beginning of 2017, due to both restrictions in Canadian lumber and an increase in domestic demand.

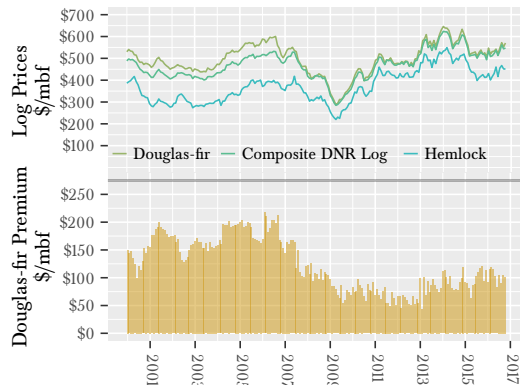
Log Prices

Figure 21 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 21 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 is primarily due to the slowdown in

demand from China and ample regional supply of both logs and lumber. A price decline was largely foreseen, though the depth of the drop was unexpected.

Figure 21: DNR Composite Log Prices



Log prices in 2016 are expected to be slightly higher than 2015 prices, held back by the same issues plaguing lumber prices, and then to begin increasing in 2017. Prices thus far have averaged \$531/mbf.

Stumpage Prices

Timber stumpage prices are the prices that successful bidders pay for the right to harvest timber from DNR-managed lands (Figure 22). 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, some sort of correction is likely to occur. For instance, in

2012 actual stumpage prices were generally lower than stumpage prices inferred from log prices, suggesting 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. As of the October 2015 timber sale, DNR stumpage prices had fallen back toward the inferred stumpage price and has remained very close to it ever since.

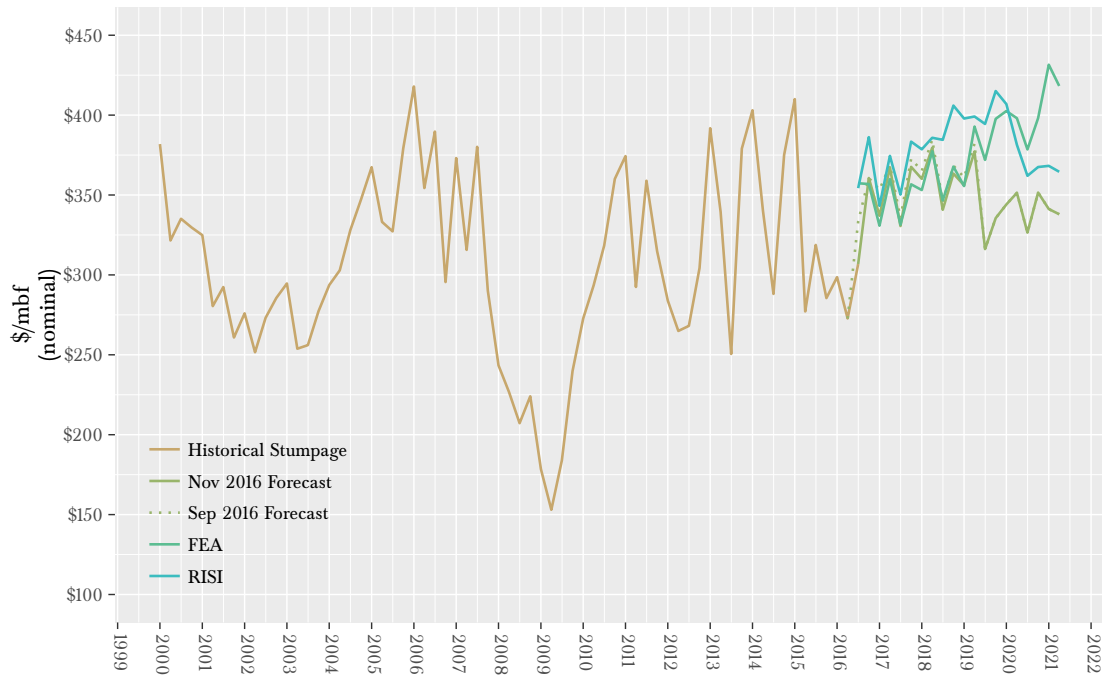
DNR Stumpage Price Outlook

DNR currently contracts with two forest economics consulting firms that provide 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 their price forecasts, we arrive at two alternative stumpage price outlooks (Figure 22, note that the RISI and FEA 'forecast' series are both adapted to reflect the species and class characteristics of typical DNR timber; the original series were West Coast averages, and are not shown).

In previous forecasts, the updated DNR Forecast represented a weighted middle ground between the two consultants' outlooks; however, in the September 2015 Forecast we took a more pessimistic view with our spot price forecasts. This decision appears to have been well founded, as both consultants lowered their price forecasts during FY 16 and DNR stumpage sales prices underwhelmed. Our updated forecast for FY 17 is somewhat more pessimistic than the median modeled stumpage prices and is still well within the range of likely stumpage prices.

It is important to note that these are nominal price expectations. In real (inflation adjusted) terms, the forecast stumpage prices will be much lower than the highs achieved during the housing boom.

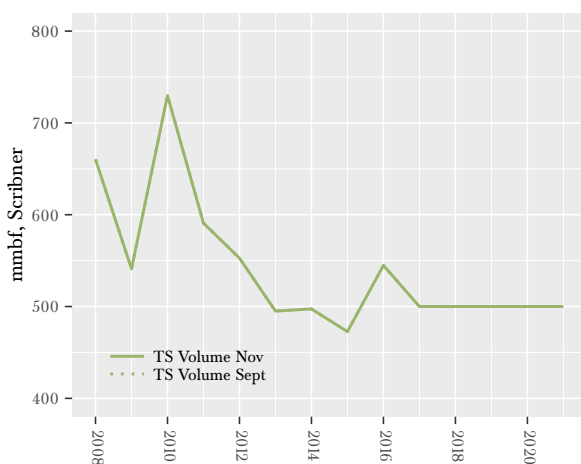
Figure 22: DNR Timber Stumpage Price



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.

Figure 23: Forecast Timber Sales Volume



Timber Revenue

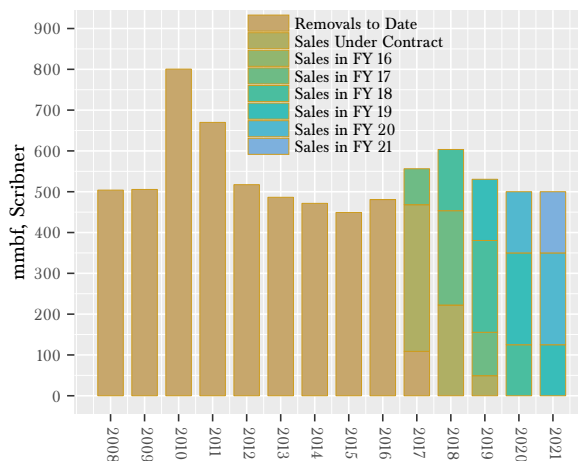
DNR sells timber through auctioned contracts that vary in duration. For instance, contracts for DNR timber sales sold in FY 2014 needed to be harvested between three months and four and a half years from the date of sale, with an average (weighted by volume) of about 25 months. The purchaser determines 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.

Timber Sales Volume

After several changes to the forecast sales volume through FY 16—largely due to the uncertainties created by the large fire season in calendar year 2015—the final volume sold was six mmbf less than expected in the June forecast (Figure 23).

Figure 24: Forecast Timber Removal Volume



FY 15 was the first year of the new sustainable harvest decade (FY 15 through FY 24) for western Washington; however, new harvest targets for the 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 17-19.

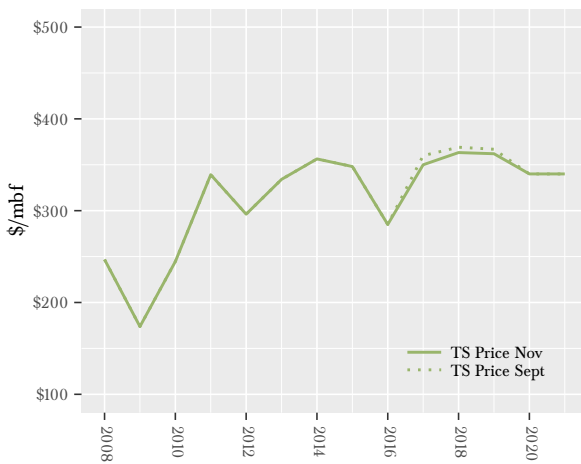
Timber Removal Volume

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. This Forecast’s survey, conducted in the first half of October, indicates that purchasers

are planning to harvest 359 mmbf of current inventory (649 mmbf) volume in the remainder of this fiscal year. Combined with harvests to-date through September and harvests expected from remaining sales in the fiscal year, FY17 the removal volume is expected to total 565 mmbf—a decrease of 43 mmbf.

The volume not harvested FY17 is expected to be harvested in outlying years (see Figure 24).

Figure 25: Forecast Timber Sales Price



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 two forest economics consulting firms.

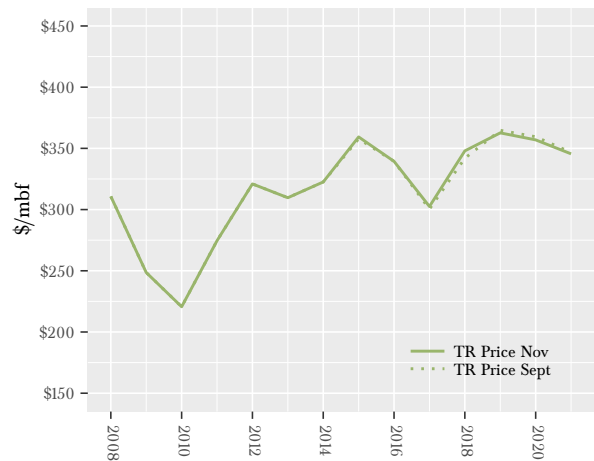
Additionally, the first four timber sales of the fiscal year had somewhat weaker prices than expected, so the price forecast for FY 17 has been reduced by \$10/mbf to \$350/mbf. Forecast prices for outlying years feature more modest reductions, or remain unchanged.

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 sold timber removed in each time period (Figure 26). Removal prices for FYs 17 through 19 differ from the September Forecast by -\$2 to +\$6, depending on changing inventory values, stumpage prices, and removal timing.

Figure 26: Forecast Timber Removal Price



Timber Removal Revenue

Figure 27 shows projected annual timber removal revenues, broken down by the fiscal year in which the timber was sold (‘sales under contract’ are already sold as of October 1st, 2016). Revenue estimates reflect all of the changes described above.

Forecast timber removal revenues for the 2015-2017 Biennium are projected to decrease by about \$11.8 million (three percent) to \$337.4 million. Forecast timber removal revenues for the 2017-2019 Biennium are projected to increase by about \$15.4 million (four percent) to \$402.4 million.

Figure 27: Forecast Timber Removal Value

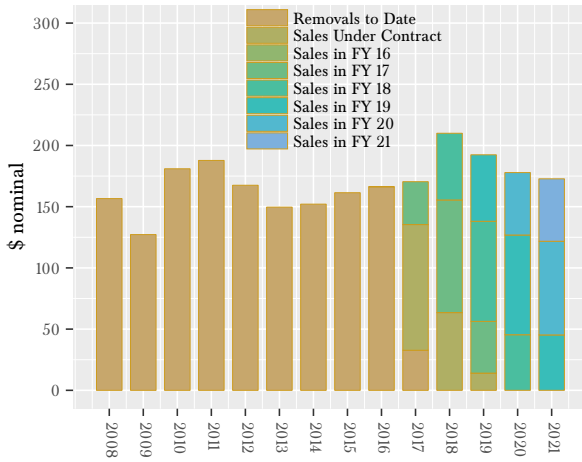
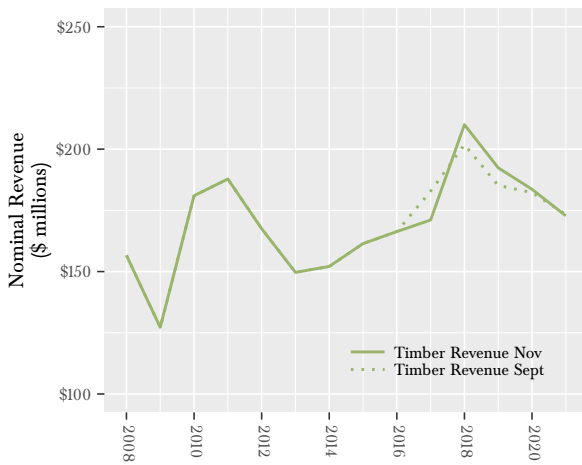


Figure 28: Forecast Timber Removal Revenue

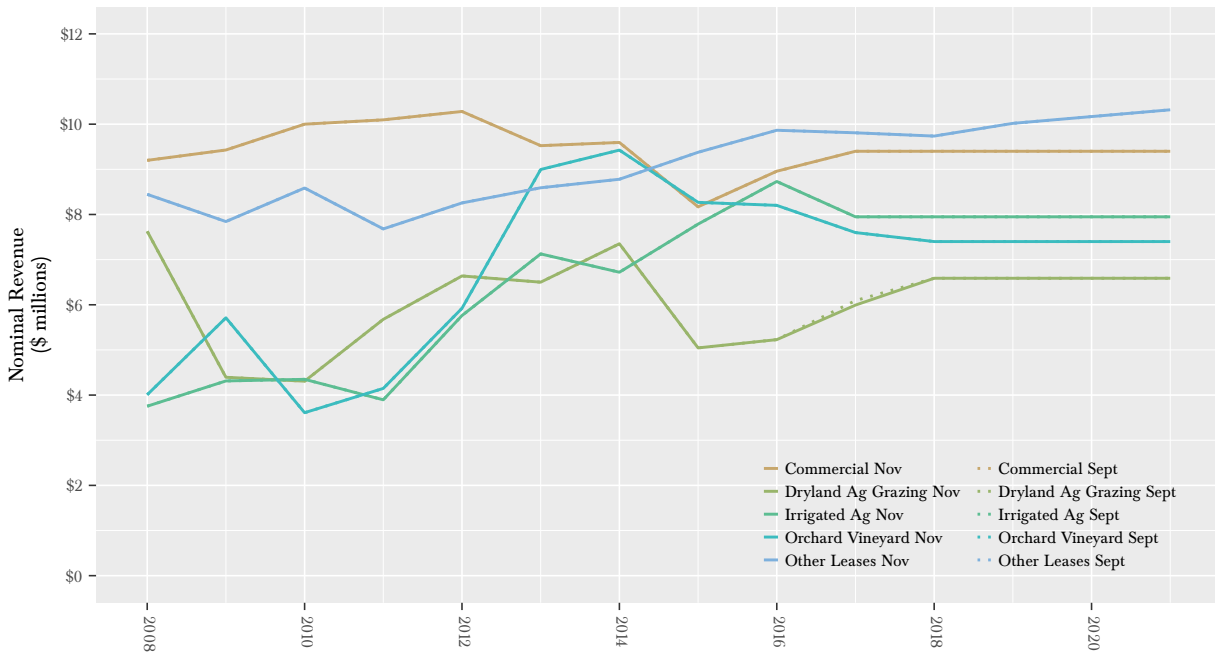


Upland Lease Revenues

Upland lease revenues are generated primarily from leases and the sale of valuable materials, other than

timber, on state trust lands. With the exception of a minor drop in expecting grazing revenues, the forecast for all categories in all years remains the same as in September (Figure 29).

Figure 29: 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 has been reduced for slightly in FY17 only, due to lower-than-expected YTD water-dependent rent revenues (Figure 30).

The geoduck revenue forecast for FY17 has been increased to \$20.2 million due to auction prices that were much higher than expected in the August auction, and to higher sales volume assumptions (Figure 31).

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 some change in the equilibrium price of geoducks—that the lower prices weren’t just part of the natural volatility of the market, but a fundamental shift in the price level. The August auction throws that speculation into question. However, given the historical volatility of the market, it seems imprudent to increase the outlying forecast prices based on one unexpectedly high price. Therefore, revenue in outlying years is unchanged.

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 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 30: Aquatic Lands Revenues

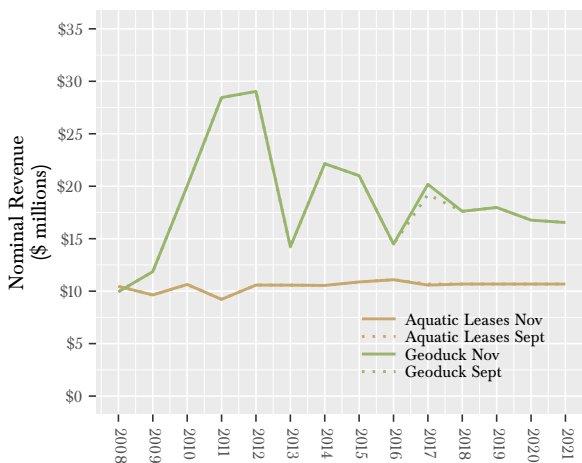
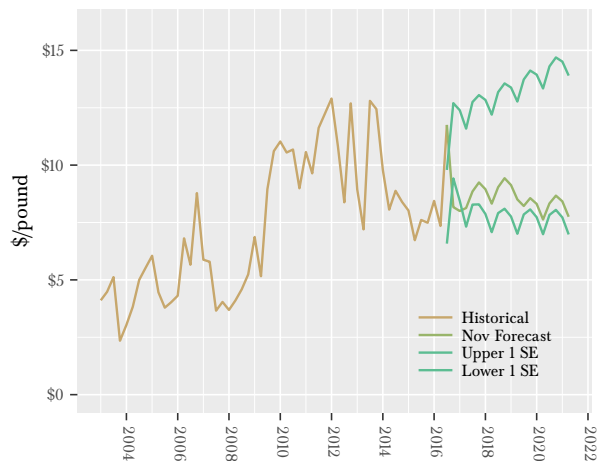


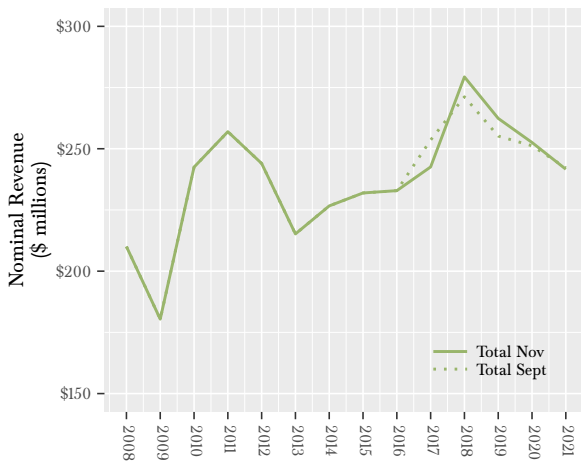
Figure 31: Geoduck Auction Prices



Total Revenues from All Sources

Forecast revenues for the 2015-2017 biennium (FYs 16 and 17) are reduced by \$11 million to \$476 million (Figure 32). This reduction is offset by an increase in revenue for the 2017-2019 biennium of \$15 million. Most of the revenue change is driven by a change in planned timber harvests and timber sales prices.

Figure 32: 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 17-18 by trust, and relative historical timber prices by DNR region by trust; and
- The volumes of timber by trust for FYs 19-21 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 over \$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 Ac-

count (FDA). In budget bills, the Legislature has authorized a deduction of up to 30 percent to RMCA since July 1, 2005, now in effect through the 2013-2015 Biennium.

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 2015-2017 biennium, but assumes that the deduction will be reduced back to 29 percent in the following biennium. This assumes that the Legislature will approve RMCA deductions of up to 30 percent, continuing its practice which started in FY 06.

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

	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
FDA	25	25	25	25	25
RMCA	31	29	29	29	29