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Corn: no room for error

Last year's drought resulted in a US corn crop that was 25% smaller than farmers' planting intentions. So despite the fact that some areas of demand are so weak, it's hardly surprising that ending stocks for the 2012-13 marketing year are the lowest they've been since the1995-96 season. The March USDA crop report estimate was equal to the February estimate, but slightly below analysts' expectation, at 16.6 million tonnes (632 million bushels), or a scant 5.6% of consumption.

The rationing process has worked well for the most part. High prices have certainly curbed export demand and have set the stage for a bumper 2013-14 crop as farmers were able to lock in their crop at historically high prices. On the domestic-demand front, however, the situation is mixed. Corn-based ethanol usage is down about 10% from last season, replaced in part by Brazilian sugarcane-based ethanol. The Department of Energy's ethanol usage statistics are roughly in line with the USDA's estimate.

Feed usage is at about the same level as last year, which is about 10% below the average of the previous 10 years. The near-term market is definitely tight, though. Cash corn prices have commanded a steep premium over May futures over the past few weeks (Chart 1). The near-term tightness is being alleviated to some degree with feed wheat substitution. Wheat prices are trading near historic lows *vis-à-vis* corn prices (Chart 2). There will be greater clarity on the domestic situation with the month-end release of quarterly stocks.

Overseas buyers are still buying US corn on a hand-to-mouth basis. Exports have been just about non-existent. Consider the statistics: Export commitments stand at 14.7 million tonnes, down from 32.1 million tonnes last year at this time. If we don't see a pick-up in foreign sales, this would be the lowest exports-to-crop ratio in modern history. The March 8 monthly crop report slashed the estimate yet again, by close to 2 million tonnes, to 20.96 million tonnes. That would be down from 2011-12 final sales of 39.18 million tonnes.

The USDA, in a manner of speaking, has written off exports for 2012-13. The low ending stock estimate already has a 50% drop in exports factored in, as illustrated above. Rightly so, because there is nothing to sell. So we don't expect to see the pace of old-crop commitments change meaningfully. In any case, South American crops are coming on stream, and near-term business for shipment before the new US crop is harvested in the fall will be the domain of Brazil and Argentina.

Actually, we believe that weak demand in all these categories is no longer a bearish factor. If anything, it could potentially be bullish. The problem is that if latent domestic and export demand rears its head, which we believe is just a matter of time, Brazil and Argentina simply do not have the volume to meet the call. Argentinean output returned to normal this year after a disastrous crop last season, and Brazil has maintained output at record levels. Exports of the two countries combined are estimated at 38 million tonnes, down from 41.8 million tonnes in 2011-12. Argentina has no room for increased exports. As it is, its ending stocks are down to 1 million tonnes, or 4% of consumption. Brazil has more ample stocks and can afford to export several million more tonnes, but would risk running its ending stocks down to dangerously low levels.

All of which means there is no room for anything but a picture-perfect US crop. Early projections for 2013-14 US acreage are about 97 million acres, equal to last year's modern-day-record area.

Our strategy for the moment is to observe from the sidelines. The market is fairly priced. Old-crop prices, hugging the

Inside

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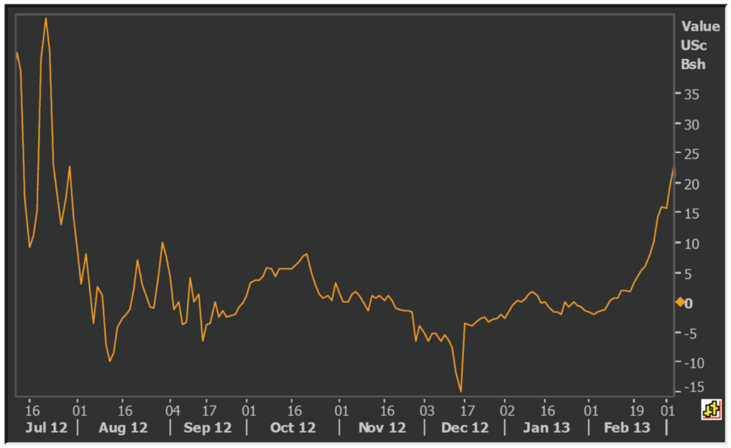
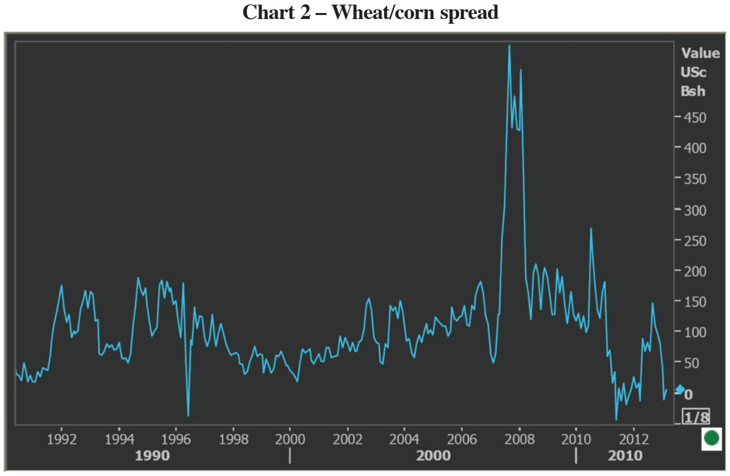
still-way-above-historical-norm $7-per-bushel level are an accurate reflection of the tightness in the domestic feed market, the absence of exports notwithstanding. New-crop December is trading $1.5 per bushel below May (Chart 3). The slightest hint of smaller-than-expected acreage or inadequate subsoil moisture would make December corn a screaming buy. The March 31 inventory and planting intentions reports will tell all. Stay tuned. *[By Sholom Sanik, March 18, 2013]*

Chart 1 – March/May corn spread



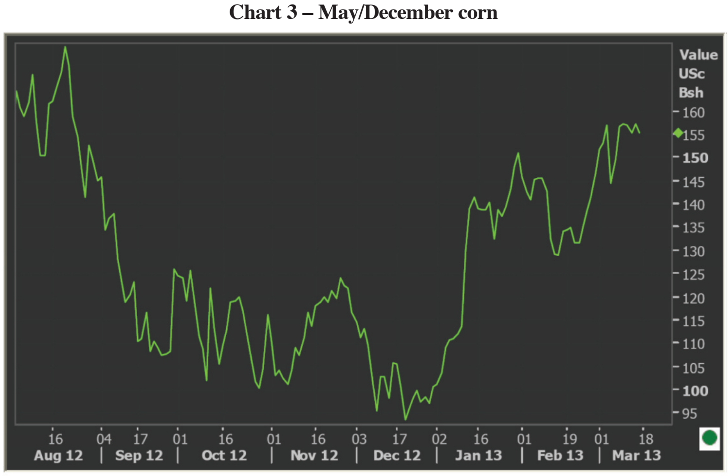
Courtesy Reuters

Chart 2 – Wheat/corn spread



Courtesy Reuters

Chart 3 – May/December corn



Courtesy Reuters

SOYBEANS

Supply set to bulge

US soybean ending stocks for the 2012-13 marketing year are estimated at 125 million bushels (3.4 million tonnes), or 4% of consumption. That would be the lowest level in history.

Unlike corn, the rationing process necessitated by last summer's drought did not materialize broadly. Domestic usage is forecast to fall below last season's by 5%, but exports have fared better than expected. The current USDA estimate for 2012-13 exports is 36.61 million tonnes, about the same as last season. Export commitments to date, however, stand at 35.49 million tonnes, with five months left to the marketing year. Last year at this juncture of the season, commitments were only 30.84 million tonnes.

Naturally, old-crop sales are going to taper off, because the US is all but sold out, and overseas buyers will be turning to South American origins until the US 2013-14 crop is harvested this coming fall. Recent activity, though, shows that there is still demand for US old crop. There were two weeks in mid-February of net cancellations, and it appeared that it was over for the season. In the following three weeks, however, sales bounced back, averaging 528,000 tonnes, which is very robust for this time of year.

Falling crush margins in China could temper its seemingly insatiable appetite for beans. The risk of further cancellations can therefore not be dismissed, but is limited because shipments have been very strong. As of the most recent export report, 31.67 million tonnes, or 86.5% of the USDA target, have been shipped. That is about the average ratio for shipments-to-final-sales at this point of the season. In the meantime, Brazilian ports are congested, with delayed shipments estimated to be as long as 50 days. On March 19 a Chinese importer canceled a shipment of 2 million tonnes because of frustration over the delay. So it's a good bet we're not likely to see heavy US cancellations over the next month or so. By that time, we should be at or near the USDA target.

Weekly export data have become the key indicator to follow to determine the direction of old-crop prices. In addition, on March 29 we'll get further insight into the domestic demand picture with the quarterly stocks report. The first comprehensive look at the 2013-14 marketing year will also come on March 29, with the release of the planting intentions report.

The USDA Outlook Forum in February provided a preliminary forecast for planted acres. Soybean area was estimated at 77.5 million acres. That would be just 300,000 acres above 2012-13 plantings and equal to the record set in 2009-10, but of course, yields are expected to bounce back. Yields for the 2012-13 drought-ravaged crop reached only 39.6 bushels per acre (bpa), down from the 5-year average of 42.2 bpa. The Outlook estimate calls for record yields of 44.5 bpa. With normal weather, US farmers should harvest 3.405 billion bushels of beans (92.8 million tonnes), 13% more than in 2012-13. That would exceed the record 3.359 billion bushels (91.5 million tonnes) set in 2009-10.

Sooner or later, South American beans will be available for shipment. The Brazilian crop is expected to reach a record 83.5 million tonnes. Argentina is bouncing back from a drought-reduced crop and is expecting a 28% jump in its crop, to 51.5 million tonnes. The market should be amply supplied.

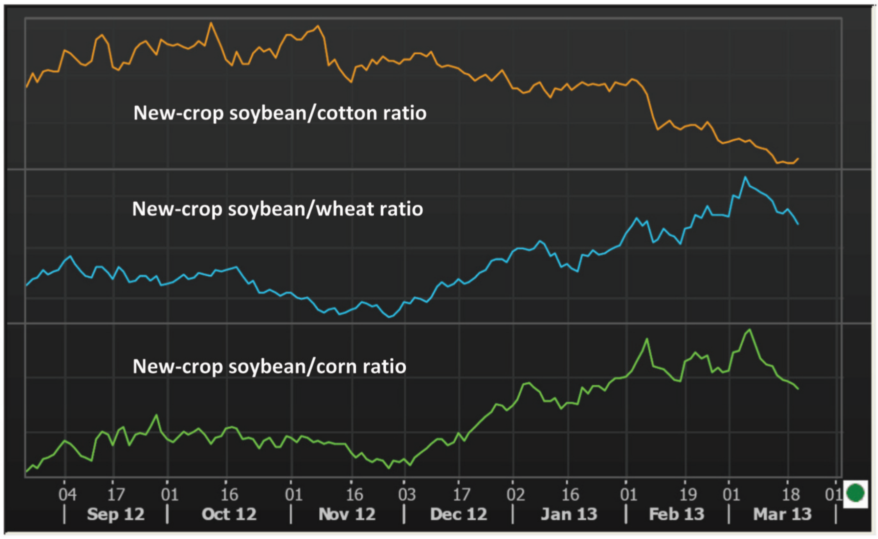
The March crop report estimated global ending stocks at 23% of usage, compared with 21.5% last season and 27.7% in 2010-11. Not large enough to get too bearish over, and low enough to leave the market vulnerable to the performance of the upcoming 2013-14 US crop.

Some estimates for US soybean acreage are substantially higher than the USDA's Outlook 77.5-million-acre estimate. Chart 4 shows that new-crop soybean prices lost ground to cotton, but, more importantly, maintained their strength throughout the entire planting-planning season against wheat and corn. So it would be a surprise if acreage did not come in near the higher end of estimates.

Stand aside, but stay tuned.

[By Sholom Sanik, March 20, 2013]

Chart 4 – New crop soybean ratios



Courtesy Reuters

NATURAL GAS

An overheated market

Front-month May natural gas futures are trading up over 20% from the February low of $3.26 per MMBtu, flirting with the top of the $3-$4 range in which prices have languished for the past year (Chart 5). The sharp rally was fueled by colder-than-normal temperatures across the US, where roughly half of homes rely on gas for heating. When measured in Heating Degree Days (a commonly referenced measure of heating demand), the first two weeks of March have been about 3.3% colder than the average of the past five years.

This increased heating demand has been reflected in higher-than-normal withdrawals from storage, with more gas coming out of storage in each of the past four weeks relative to the same period during the past five years. Though, when viewed in the context of total gas in storage (i.e., in percentage terms), the withdrawals have been completely in line with historical norms. Market bulls have made hay about the large decline of gas in storage year-over-year, though this is misleading, because last year was an aberration (Chart 6). When measured against the five years before 2012, there is 14.1% more gas in storage for this time of year. The fact is, weather can have a short-term impact on natural gas prices, but the long-term fundamentals remain in place.

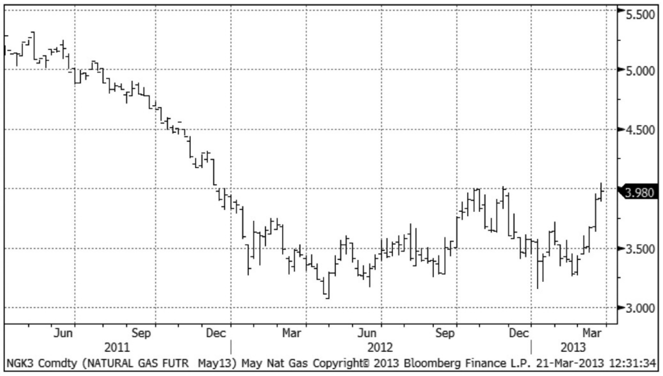
Since the expansion of shale gas exploration began in earnest in 2005, US domestic production of natural gas has been on a steady march higher (Chart 7), with demand unable to keep pace with the growing supply. This has effectively capped the upside for natural gas prices in the US, trapping spot prices in a tight range. Long-term prospects for higher prices are developing; however, the realization of higher natural gas prices is still a distant event, one that will be discussed in detail in a later note.

Adding further wind to the sails for short sellers is the persistently positive roll yield in the natural gas forward curve. Over the past 12 months, shorts have earned a cumulative return of about $1.08 rolling their positions each month, a substantial profit equal to roughly 25% of the underlying price of gas at current levels. While the forward curve has flattened in recent months, the positive carry persists, and natural gas front-month spreads have demonstrated a consistent tendency to widen as they approach the roll date.

We have been long-term bears on natural gas, and given the overbought condition of the market coupled with recent weather reports calling for above-normal temperatures beginning in April, now is a good opportunity to establish a new short position. Sell May natural gas, placing initial stops at $4.40.

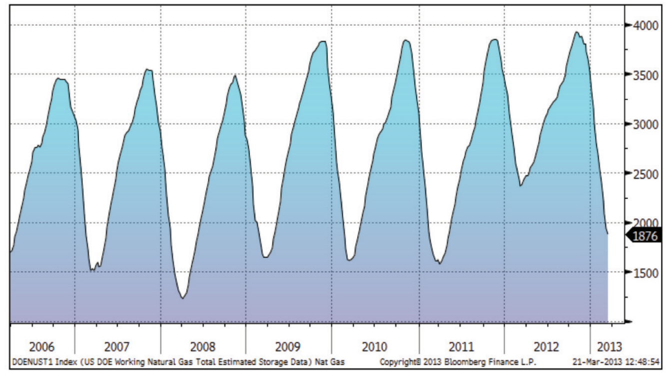
[By Jaime Macrae, March 22, 2013]

Chart 5 – May 2013 NYMEX natural gas



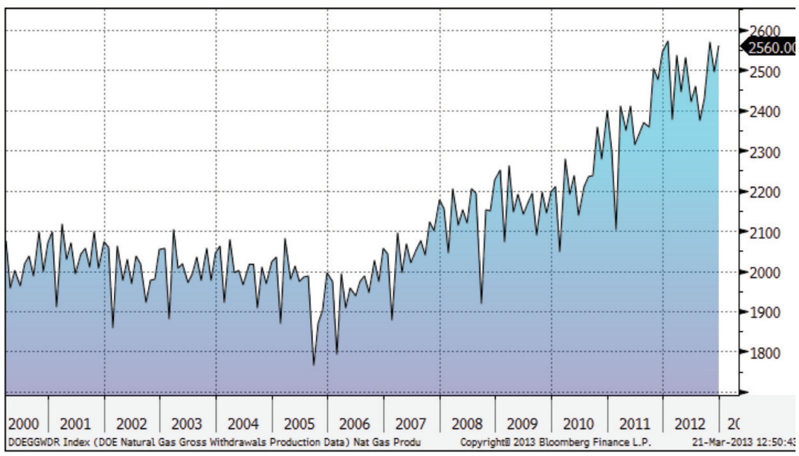
Courtesy Bloomberg LP

Chart 6 – US DOE working natural gas total estimated storage



Courtesy Bloomberg LP

Chart 7 – US DOE natural gas production



Courtesy Bloomberg LP

CANADIAN DOLLAR

A commodity currency

When it comes to the relationship between the Canadian dollar and commodity prices, the headline benchmark prices can be misleading. Chart 8 displays the relationship between the Canadian dollar and the price of Western Canada Select (WCS) crude oil. As Canada's most high profile export, it is a key driver of US-Canada terms of trade. The Bank of Canada pays close attention to the value of domestic crude prices. In its most recent *Monetary Policy Report* the BoC singled out the record discount of WSC to global benchmarks like WTI in Cushing (a result of persistent transportation bottlenecks) as putting pressure on "Canada's terms of trade and real gross domestic income" (Chart 9).

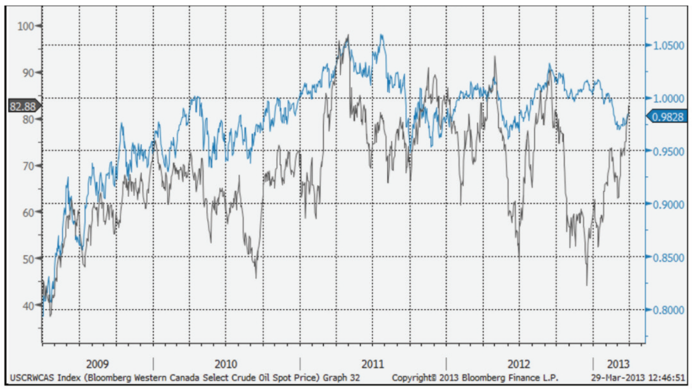
Back in mid-September of 2012, the price of WCS crude oil experienced a severe downturn that saw the value of Canada's largest export fall over 51%, bottoming out in mid-December at a mere $44.23 per barrel. This bear market, largely the result of the aforementioned transportation bottlenecks that restricted exports, coincided with the speculative community shifting *en masse* from a record net-long position, to holding one of the largest net-short positions of all time (Chart 10). Since marking its low in December, WCS crude has risen over 85%, while speculators have continued to short the Canadian dollar. This has resulted in a divergence from the historically positive correlation between the price of crude oil and the loonie, with WCS rising while the Canadian dollar fell. So far, the shorts have been on the right side of the trade. However, with the oil picture shifting substantially in Canada's favour, a significant short covering could be in the offing.

It is worth noting, though, that unlike most commodity futures, where the exchange-traded markets set the global benchmarks, currencies trade primarily outside the purview of the CFTC, and therefore the Commitment of Traders report does not provide a complete picture of how the market is positioned. However, FX dealers are reporting similar trends among their own speculative clients, so the COT data would seem to serve as a reasonable proxy for the underlying market.

The Canadian dollar is now near the low end of the range in which it has traded over the past 18 months, and April is seasonally the Canadian dollar's strongest month, with the most frequent positive returns and highest average returns. Given the heavily short position of the speculative community, and early reports of those positions being unwound, now would seem an opportune time to enter a new long position in the currency. Buy June Canadian dollar, placing initial stops at 95.50, close only.

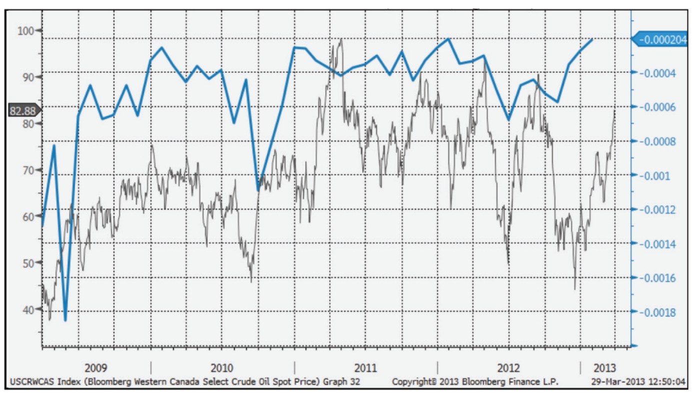
[By Jaime Macrae, April 1, 2013]

Chart 8 – Western Canada Select crude oil (left axis) and Canadian-US dollar exchange rate (right axis)



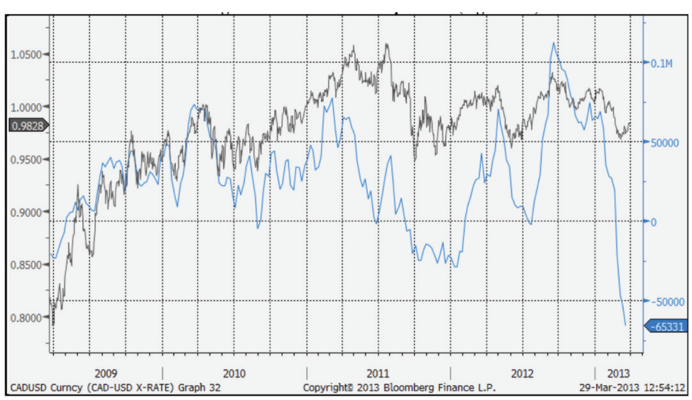
Courtesy Bloomberg LP

Chart 9 – Western Canada Select crude oil (left axis) and US trade balance with Canada (inverted, right axis)



Courtesy Bloomberg LP

Chart 10 – Canadian-US dollar exchange rate (left axis) and CFTC large non-commercial net position (right axis)



Courtesy Bloomberg LP

CORN

Prices sink as the USDA 'finds' 400 million bushels

Heading in to the March 28 USDA quarterly stocks report, US 2012-13 ending stocks were forecast to drop, from 989 million bushels in 2011-12, to 632 million bushels, or 5.6% of consumption, the lowest level in 17 years. As we detailed in our last report on corn (*Focus on Futures*, March 18), despite the fact that US exports have been anemic all through the marketing year, strong domestic demand had "seemingly" tightened the market. Old-crop prices remained stubbornly high, and spot was commanding a hefty premium over futures.

The quarterly stocks report dispelled any such notion: The USDA reported March 1 stocks at 5.398 billion bushels, close to 400 million bushels above the average of analysts' guesstimates. That was a huge miss.

The response was appropriate, prices fell the 40¢-per-bushel daily trading limit, gapped lower the following day, and have since dropped to about $1 per bushel below the settlement price of the session prior to the report (Chart 11).

To say that the report was a surprise is an understatement. Explaining the sharp divergence from the hard evidence of very strong spot premiums – which incidently continue to hover at about pre-report levels – presents a bit of a challenge. The USDA – in the words of analysts – "found" the 400 million bushels. One theory is that domestic demand has in fact been just as strong as the spot premiums indicate, but that the drought-stricken 2012-13 crop was actually underestimated.

If the USDA stands by the data, the estimate for ending stocks should jump by a similar amount in the April 10 monthly crop report, to over 1 billion bushels.

That would alter the landscape significantly. If there are no major changes in all other categories, that would see stocks as a percentage of usage climb to about 11.5%, a far more comfortable zone. There have been instances, however, in which the quarterly stocks report was inconsistent with the crop report that followed. While not quite as dramatic, a year ago, the quarterly stocks report was 140 million bushels below expectations, but the estimate for April ending stocks was virtually unchanged from the March estimate.

There haven't been any weekly export reports since prices tumbled. It will be interesting to see if the sharp drop will stimulate any traditional US business for old-crop corn that was lost to sticker shock.

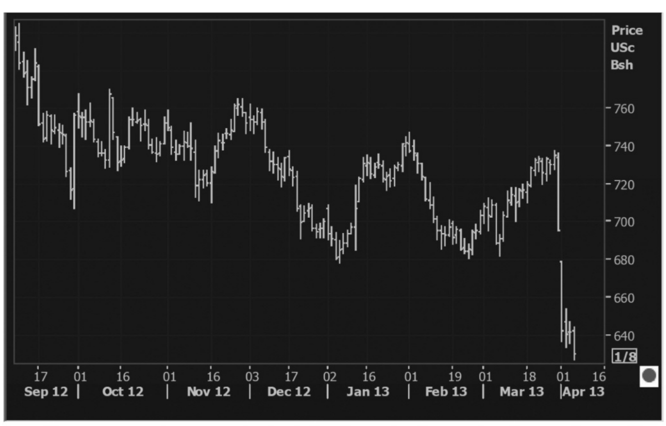
The other important report released on March 28 was planting intentions for the 2013-14 season. The estimate came in at 97.282 million acres, just 30,000 acres above the average trade guesstimate. Headlines declared the results to be bearish for new crop months, but it should be considered to be in line with expectations. Even with optimum yields, those extra acres will grow about 4 million bushels.

Prices of new crop contract months have fallen by 30¢ per bushel (Chart 12) since before the report, but for the most part, a record 14-billion-bushel crop had already been priced in.

In the meantime, bird flu and a pork disease in China threaten the slaughter and disposal of significant numbers of corn-consuming chickens and hogs. Not to mention consumers fears', which may lower demand.

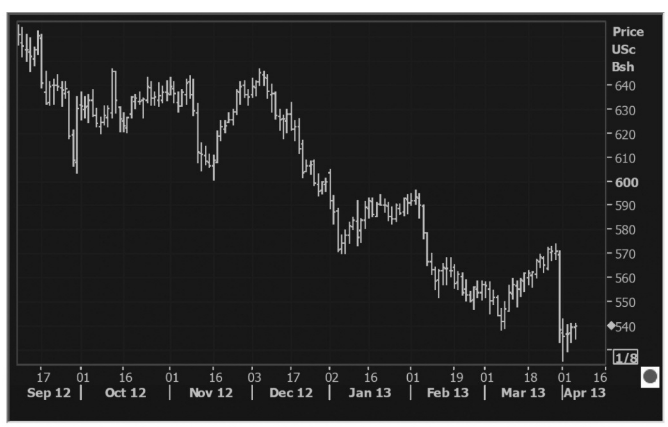
The inventory report has created a fair amount of uncertainty. We are going to continue to remain sidelined at the present time. Late-season snow and rainstorms have replenished some much-needed sub-soil moisture in corn-growing regions. By the same token, though, the wet weather has slowed planting progress and has jeopardized high-yielding early corn plantings. Our only recommendation is to follow the weather and buy new-crop months at the slightest hint of a disappointing crop. *[By Sholom Sanik, April 5, 2013]*

Chart 11 – May corn



Courtesy Reuters

Chart 12 – December corn



Courtesy Reuters

JAPANESE GOVERNMENT BONDS

A recipe for disaster

"Abenomics" has taken the center stage in the world of finance. Elected on a platform of aggressive action designed to spur growth and end deflation, Japan's Prime Minister Shinzo Abe pledged to target 2% inflation, correct the excessive strength of the yen, and effectively set negative interest rates through radical quantitative easing. The Japanese yen began its dramatic decline even before he was elected (Chart 13), and continued its slide with the placement of Haruhiko Kuroda at the helm of the Bank of Japan. Kuroda, in turn, exceeded the market's expectations with aggressive ultra-easy money policies at his first Bank of Japan (BoJ) meeting last week.

The most surprising aspect of his policy shift was the change to targeting the monetary base, rather than the overnight call rate. To that end, Kuroda pledged to increase the monetary base by ¥60-70 trillion per annum (compared with ¥13.4tn in 2013 and ¥16.5tn in 2012), and effectively double it by December 2014. To achieve this goal, and reach the desired 2% inflation target (again, within two years), the BoJ will increase Japanese government bond purchases to ¥50tn per year up from the current ¥20tn, and extend the average maturity of its portfolio to 7 years from less than 3 currently.

The takeaway from the policy move is that the BoJ, in partnership with the Abe government, is very serious about ending the decades-long deflation that has plagued Japan.

Shortly after the announcement, 10-year JGB yields fell to an all-time low of 32bps intraday, before doubling to a high of 64bps during the same session. The heightened volatility in the JGB market has persisted over the past several sessions (Chart 14). One can easily see parallels between the new BoJ policy and the current Fed policy of aggressive quantitative easing that has propped up Treasury prices and kept a lid on US yields over the past few years. Japan, however, is in a much more precarious fiscal position, and aggressive moves towards spurring inflation risks creating an insolvency crisis that could punish JGB investors.

Short positions in the JGBs have long been popular with traders who understand the vulnerability of Japanese government finances; however, the persistent falling yields have earned this trade the moniker "the widowmaker." Given the BoJ's aggressive move to escape deflation, now might be the time to be short the JGBs. Chart 15 shows the percentage of Japan's central government's tax receipts that goes to paying interest on its outstanding debt. Keep in mind that after almost two decades of zero or near-zero interest rates, the weighted average cost of capital on Japan's outstanding debt is less than 100 bps.

Japanese investors, primarily through institutions and pension funds, have been reliable purchasers of JGBs, even at yields that would be considered paltry compared with any other developed country's bonds. But when you consider the horrible negative returns offered by Japan's equity and real estate markets over the past two decades, and the effect of deflation on real yields, it is not hard to see that despite the low nominal yields offered by JGBs, they have been the best investment available in Japan.

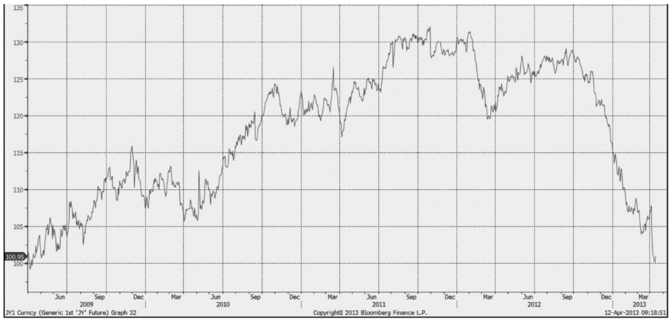
When we measure the total indebtedness of the Japanese government against its annual tax revenues (Chart 16), we see that debt has soared over the past decade and now exceeds 22 years of total government revenue. Obviously, the Japanese government will be hard-pressed to repay its debt, and with the interest expense on this debt already soaking up roughly a quarter of their tax take, any rise in interest rates could result in a solvency crisis. What, then, is the government expecting to happen if/when it gets inflation to the target of 2%?

On the surface, JGBs would seem to be a slam-dunk short. However, with the BoJ planning to purchase ¥50tn worth of JGBs each year, who will prevail? In the wake of the central bank's announcement, investors have been caught between the knowledge that the BoJ will be backstopping the bond market, but unenthusiastic about accepting record low yields when there are ample opportunities elsewhere.

The catalyst has yet to materialize, but keep an eye out for signs of changes in participants' behavior. Japan's largest pension fund is currently reviewing its JGB position, worth about ¥60 trillion. If it, or the other institutional investors who have kept the Japanese bond market afloat, start to move money into foreign bonds (which is now more favourable given a falling yen), or into Japanese equities (which are experiencing a resurgence on the heels of the BoJ stimulus), it could spell the end for the Japanese government's Ponzi scheme.

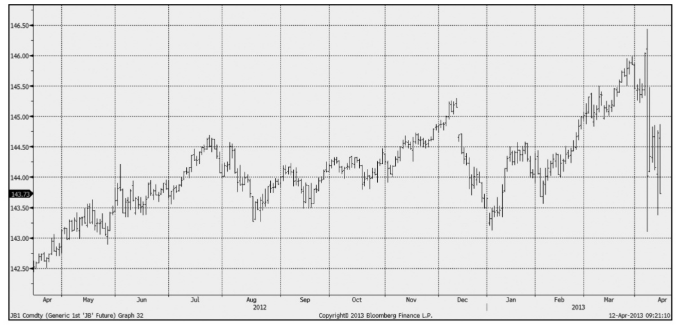
[By Jaime Macrae, April 12, 2013]

Chart 13 – Front-month Japanese yen futures



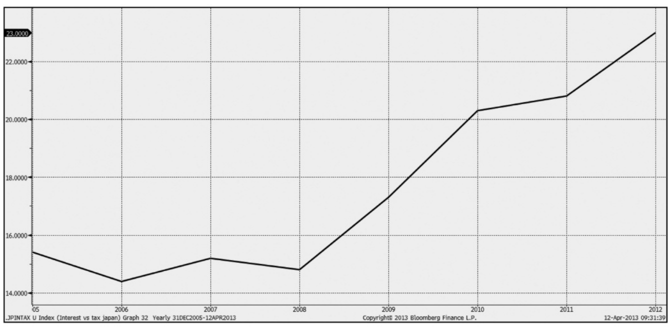
Courtesy Bloomberg LP

Chart 14 – Front-month JGB futures



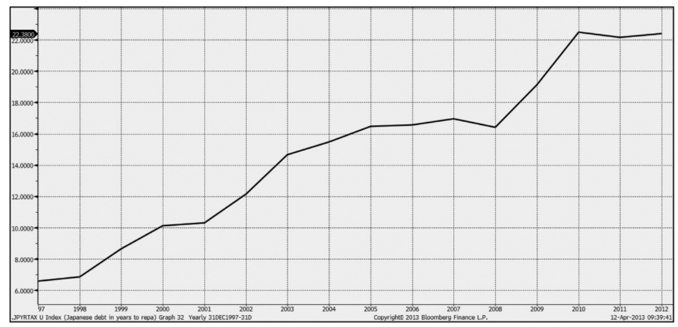
Courtesy Bloomberg LP

Chart 15 – Proportion of Japense central government tax receipts paid in interest on government bonds



Courtesy Bloomberg LP

Chart 16 – Total Japanese government debt over annual tax revenues



Courtesy Bloomberg LP

WHEAT

Is the bull just resting, or have we met the bear?

The April USDA crop report presented a bearish picture for the global wheat market, reaffirming the steep slide in prices we've seen over the past six months. With the 2012-13 marketing year drawing to a close, analysts were expecting a featureless report. The USDA "found" some wheat, though, raising the estimate for 2011-12 carryover stocks by three million tonnes and lowering this year's consumption by a little more than one million tonnes. The resulting increase in inventories puts 2012-13 ending stocks at 182 million tonnes, or 27% of consumption, up from 26.5% last month. Although that is still lower than 28.6% in 2011-12 and 30.4% in 2010-12, it has been inching higher since earlier in the season, when the estimate was below 26%.

Late snowfalls and cold weather this winter have been a mixed blessing for the US winter wheat crop. On the one hand, the moisture is welcome after last year's extreme drought conditions, in the hope that subsoil moisture levels will be replenished. On the other hand, emerging crops in some regions – particularly in key growing states Kansas, Oklahoma, and Texas – are being harmed by freezing temperatures. Spring wheat planting is being delayed in yet other areas due to flooding.

The estimate for US 2013-14 all wheat acreage – that's the winter wheat crop planted last fall and the spring wheat crop to be planted this spring – is 56.44 million acres, up 1.2% from 2012-13. With the weather situation as it is, however, it does not necessarily mean that the crop will be much bigger than last year's. Last year's average yield was a record 46.3 bushels per acre and the harvested-to-planted ratio was a much-higher-than-average 88%. A tough act to follow if weather conditions do not improve.

As of the most recent USDA crop progress report, only 36% of the winter wheat crop was in good-to-excellent condition, down from 64% last year at this juncture of the season.

Most of the Northern Hemisphere wheat areas – including Canada, Europe, and China – are experiencing extended winter conditions, similar to that in the US. Large crops are expected, but can hardly be considered a certainty until the effects of potential freezing temperatures are known.

The International Grain Council forecasts a sharp increase in global production for 2013-14 of 5%, to 690 million tonnes, but estimates that consumption will increase to the same level, so inventory levels would remain at about the same level as this year. The optimistic output estimate is based on expanded plantings and will, of course, depend on the success of the winter wheat crops, which as illustrated, can go either way at this point.

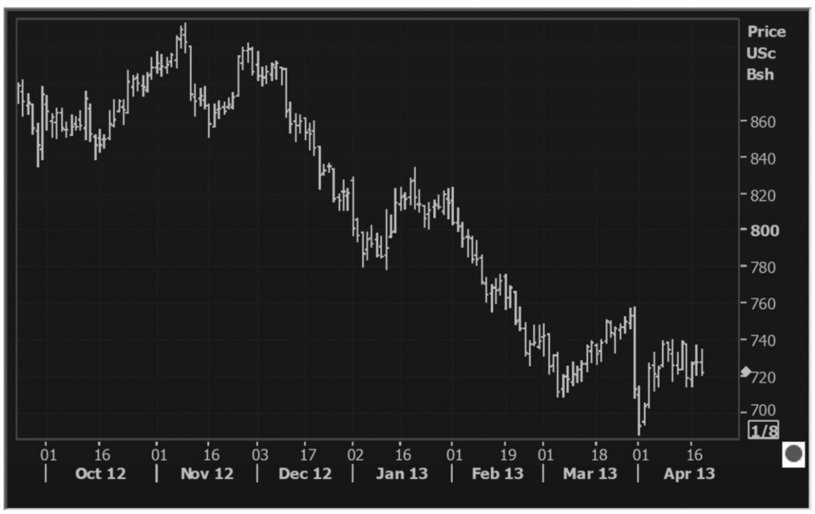
The demand side looks encouraging. On April 11 China embarked on what is reported to be a restocking program and bought 360,000 tonnes of US new-crop wheat, the largest single-day purchase since 2004. A few days later, that was topped up with yet another purchase of 480,000 tonnes. China has been largely self sufficient in wheat in recent years, importing at most three million tonnes in some years and next to nothing in others. Introducing China as a buyer is definitely a bullish factor.

At the moment, there is no compelling reason to buy or sell this market. With the risk of smaller-than-expected Northern Hemisphere crops, we would definitely not trade from the short side, because the market has already priced a good crop. While the weather can improve, there is a low probability of achieving optimum yields. Lack of improvement for winter wheat crops and some steady Chinese buying would spark a price recovery.

Stand aside for now, but follow further development of these factors. A very low-risk buying opportunity in new-crop contract months might present itself (Chart 17).

[By Sholom Sanik, April 18, 2013]

Chart 17 – December wheat



Courtesy Reuters

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