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Rising yields: a bullish signal for equities?

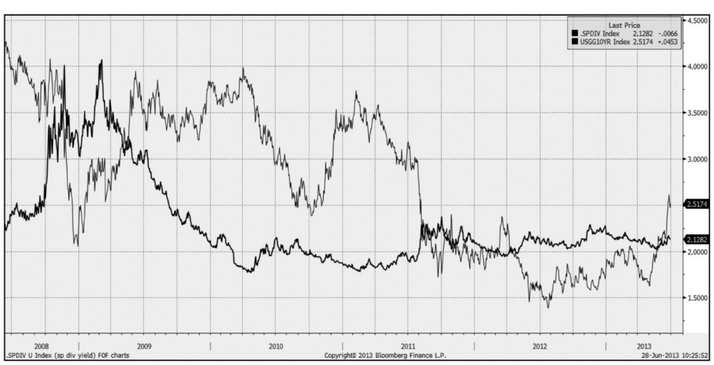
The sharp rally in 10-year US Treasury yields seen since the start of May has pushed government bond yields above the average dividend yield for US equities, removing one of the strongest tailwinds supporting the rally that took the S&P 500 to new all-time highs (Chart 1). Conventional wisdom dictates that this should be a negative for stocks, as the yield gap between debt and equities generally favors the riskier equity assets. In addition, higher yields translate into higher corporate borrowing costs, which act as a drag on economic growth and put pressure to equity prices. When viewed in this context, the bull market in equities may be facing some headwinds going forward.

What's missing from the "conventional" wisdom above is the source of the rising yields, as there are numerous reasons for bond yields to rise. In the current context, yields are rising from an exceptionally low starting point, one that was designed to breathe life into a listless economy, and rescue a housing market from a devastating crash. With that in mind, rising yields are an indication of an economy that is picking up speed, which is hardly a negative for corporate earnings and by extension, equity valuations.

Beyond a certain point, however, rising yields do start to act as a drag on the economy. Based on our quantitative study of the relationship between 10-year nominal US Treasury yields and the price-earnings ratio of the S&P 500 Composite Index, that tipping point is around 5%-6% (Chart 2). The red asterisk on Chart 2 indicates the current 10-year Treasury yield and the current S&P 500 p/e ratio. If the historical relationship between government bond yields and equity valuations holds, and Treasury yields continue to rise, so should equities – up to a point.

Whether yields continue to rise, however, is far from assured. The current rally, at its peak on June 25, took the 10-year Treasury yield over 30% above its 50-day moving average, the largest relative rally in at least 50 years (Chart 3). Given the extent of the rally, it may well be overextended. *[**Jaime Macrae**, July 1, 2013]*

Chart 1 – S&P 500 dividend yield vs. US 10-year Treasury yield



Courtesy Bloomberg LP

Inside

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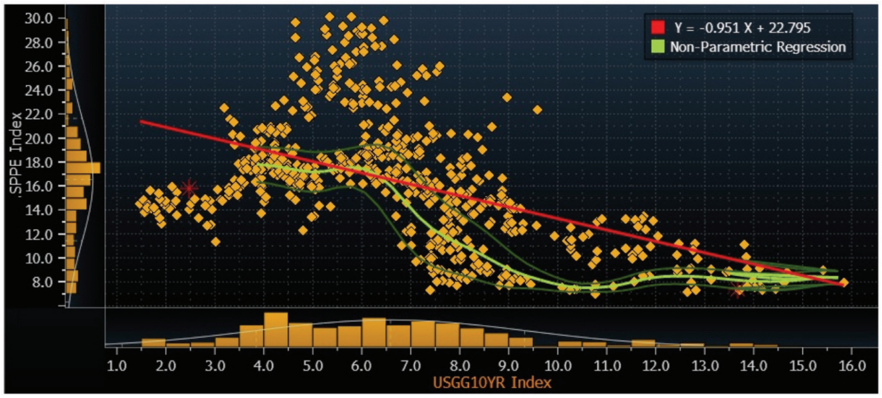
Chart 2 –Regression study of 10-year nominal US Treasury yield



Courtesy Bloomberg LP

Chart 3 – US 10-year Treasury yield

Courtesy Bloomberg LP

SUGAR

Out of sync with fundamentals

After a brief relief rally, the sugar market has returned to its bearish ways. Over the past year, the market has rallied leading up to – and sometimes after – the expiry of the front-month contract, as seen in Chart 4. In all likelihood, the rallies were the result of covering by shorts who wanted to book their profits and did not wish to roll over their positions. The expiry of the July 2013 contract on June 28 was certainly due to short covering, as evidenced by the over-100,000-contract drop in open interest and the contraction in the net-short position held by funds (Chart 5).

There have been some developments on the fundamentals front.

Wet weather in Brazil during the first half of June hampered sugar crushing, prompting larger-than-expected ethanol production. It's been drier over the past few weeks, but sugar output was down enough for analysts to revise their sugar output forecasts. Some estimates for 2013-14 output have fallen by more than 2 million tonnes. Unless there is an unexpected shift in the ethanol/sugar ratio as the crushing season develops, we are no longer looking at record sugar production. Original estimates called for over 35 million tonnes, but the tally now looks to be closer to last year's output of about 34 million tonnes.

The government incentives for ethanol producers – not to mention competitiveness spurred by the fact that crude oil is trading over $100 per barrel – have been effective. Output in the center south region, where 90% of Brazilian cane is grown, will be 25.7 billion liters, up from an earlier forecast of 24.5 billion liters, and compared with only 21.4 billion liters for the 2012-13 season.

The ethanol/sugar ratio is estimated at 55.2%/44.8%, above a previous forecast for 53.5%/46.5%, and compared with 50.5%/49.5% in 2012-13.

Last season we saw wild swings in the estimates for Brazilian sugar production because of alternating favorable and unfavorable weather systems, and there is no reason not to expect the same this year. So while the change in the outlook for Brazil is clearly bullish at the moment, it is not carved in stone. Certainly this is the view of traders who have pushed front-month October to new lows in recent days.

Another potentially bullish factor down the road – which has also made no impression at all on bears – is early forecasts for 2013-14 Indian production. Fears of a poor monsoon have passed. The monsoon arrived on time in early June, and the rains have been at above-average levels in cane-growing regions. Still, Maharashtra province, the largest-producing region in India, continued to suffer from last year's drought, and cultivated area fell by 25%. That would draw down Maharashtra province output by about 2 million tonnes, to 6 million tonnes.

Overall, Indian sugar output is estimated to fall to about 22 million tonnes in 2013-14, down from 24.6 million tonnes in 2012-13. Last year's consumption was 23.6 million tonnes, and with a growing population, it is inconceivable that usage will not be at least as much. This will leave India with a production/consumption deficit and the need to tap into inventories.

The government's liberal export policy facilitated exports of over 3 million tonnes in each of 2011-12 and 2012-13. For this coming season, however, analysts have acknowledged that new supplies will be much tighter than in recent years. Exports are estimated to be negligible, at about 500,000 tonnes in 2013-14.

At this point, the global balance sheet is still expected to show a production/consumption surplus for 2013-14, but all the major sugar analysts have been inching their forecasts down. The average estimate calls for a surplus of about 4 million tonnes, compared with close to 10 million tonnes for 2012-13.

Finally, as we've mentioned many times in these pages, the cost of production has moved up substantially over the past few years. If the world sugar price at 20¢ per pound proved to be a disincentive to sugar cultivation, it has certainly become a much larger factor at 17¢ per pound.

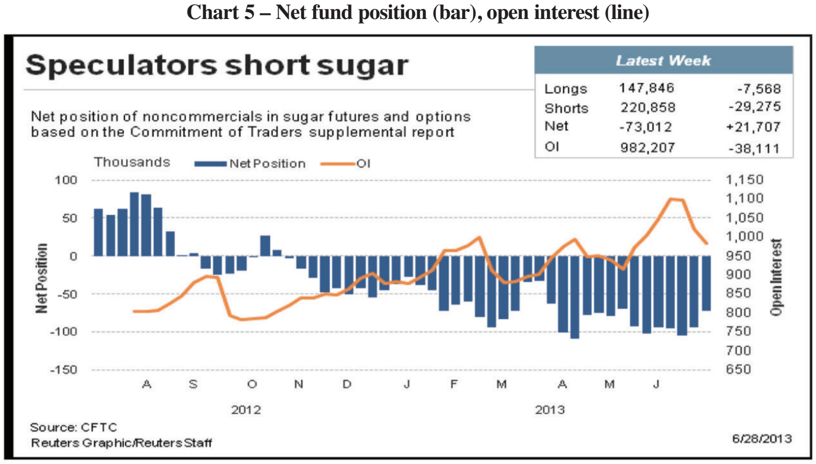
We continue to believe that the purchase of out-of-the-money calls will prove to be rewarding, even if repeated several times.

*[**Sholom Sanik**, July 5, 2013]*

Chart 4 – Nearest contract ICE sugar

Courtesy Reuters

Chart 5 – Net fund position (bar), open interest (line)



Courtesy Reuters

PLATINUM GROUP METALS

The baby went out with the bathwater

Within the commodity space, perhaps the most bullish fundamentals belong to the Platinum Group Metals (PGMs). Both platinum and palladium have similar industrial and commercial uses as well as demand growth, and both suffer from less than secure supply. In our June 5 note entitled "Platinum: time to shine," we espoused the bullish case for platinum, based on the potential for supply disruptions stemming from contract renegotiations in South Africa. We recommended a long position with a protective stop at 1430 (basis July), which unfortunately did not hold in the face of a Fed-inspired selloff in gold that saw the yellow metal fall over $200, and which took the rest of the precious metals down with it. Fortunately, this has presented an opportunity to establish new long positions at more favorable prices.

The situation in South Africa is as perilous as ever. Last week an illegal wildcat strike shut down production at two of Anglo American Platinum's (the world's largest platinum producer) mines in the Rustenburg area. Workers have since returned to the mines; however, the incident is indicative of a heated atmosphere where unexpected labor actions can idle production at any moment.

Meanwhile, the two unions that dominate the mining industry are competing for members and trying to show their relative strength by playing hardball with the mining companies. At this summer's annual labor negotiation's kickoff, both unions made record demands on gold producers, with the NUM asking for as much as a 60% increase in pay and the upstart AMCU demanding that wages be doubled.

The unprecedented demands on gold producers are a clear sign that platinum producers will face similar pressure from unions. South Africa produces 73% of the world's platinum and 36% of the world's palladium. Meanwhile, on the other side of the globe the largest producer of palladium, Russia's Norilsk Nickel, warned earlier this week that without new projects, the persistent deficit in palladium supply will double to 2 million troy ounces by 2020. The most recent Johnson Matthey report revealed that while new supplies of palladium were just 6.5 million ounces in 2012, demand reached 7.6 million ounces – and demand is starting to pick up.

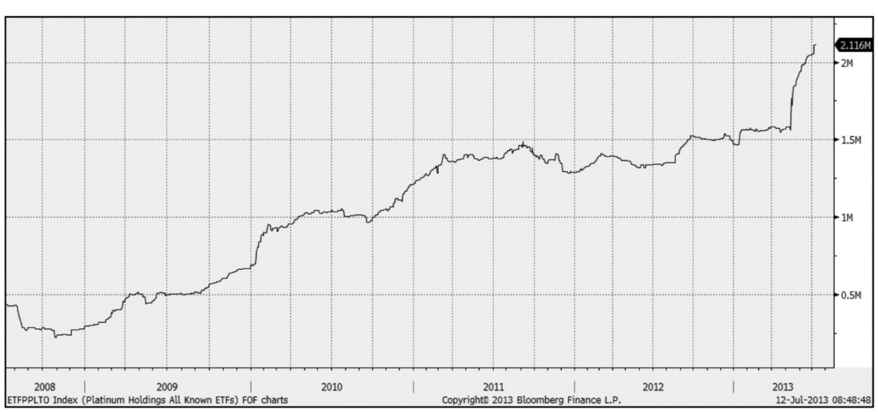
The most important use of the PGMs is in autocatalytic converters, which reduce the pollution in emissions from vehicles. With the economy starting to recover in North America, and the Chinese automobile market now the third-largest consumer of PGMs, demand is only going to rise, since no economically viable alternative to PGM use in autocatalytic converters has yet to be found. Beyond the growth in the absolute number of cars built, it is the move towards stricter emission standards that will drive demand higher. Last year, while Chinese car sales grew only 5.2%, palladium and platinum demand grew 11% and 10%, respectively, due to the implementation of China 4 emission standards.

The final wildcard to the PGMs is investment demand, which has been brisk. Charts 6 and 7 show the inflows into physically-backed ETFs for both metals, and demand for platinum has been particularly strong. It's no wonder investors are flocking to the PGMs, which have outperformed the more traditional precious metals (gold and silver) by a wide margin over the past several months (Chart 8).

The risk remains that another leg lower in the gold market could drag the PGMs down with it; however, at current prices both represent good value and stand out as rare bastions of fundamental strength in an otherwise lackluster market for commodities.

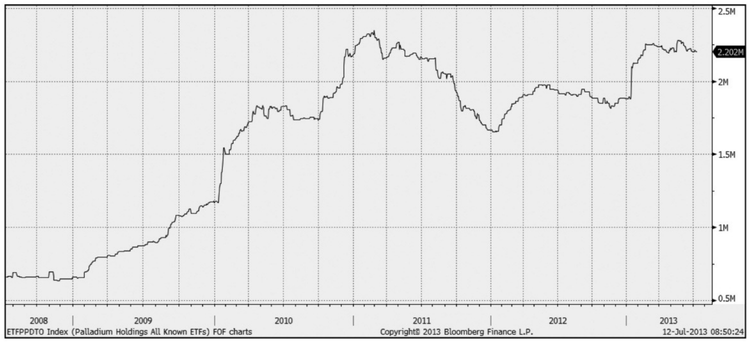
*[**Jaime Macrae**, July 12, 2013]*

Chart 6 – Platinum total holdings of all known ETFs



Courtesy Bloomberg LP

Chart 7 – Palladium total holdings of all known ETFs



Courtesy Bloomberg LP

Chart 8 – Platinu7m, palladium, gold, and silver – normalized

Courtesy Bloomberg LP

COTTON

Chinese inventories may usher in the bear

Global cotton output is expected to fall by 2.6% from the previous season, to 118 million bales, while consumption is expected to grow by 2.2%, to 110 million bales. Still, the balance sheet for the global cotton market is set to record yet another production/consumption surplus that will be heaped on top of burdensome carryover stocks from the 2012-13 marketing year. Ending stocks are estimated to grow to a record 94.34 million bales, or a staggering 85.9% of usage. That's up from 79.6% last season and 68.9% in 2011-12.

What's been keeping the market afloat, and whatever it is, can it last?

The US is the world's largest exporter of cotton, so there is a heavy focus on the US crop. Planted area was 17% below last year and 30% smaller than in 2011-12. The crop was planted very late because of an exceptionally wet spring. Some key growing regions in Texas are now experiencing severe drought that will probably result in a high rate of abandonment.

Average national yields are expected to suffer, falling to 831 pounds per acre, compared with 887 pounds per acre last year. In the July crop report, the USDA raised its acreage and yield estimates, but also increased its estimate for abandoned acres, leaving the forecast for the crop unchanged from June at 13.5 million bales. That will be the smallest crop since 2009-10.

The supply side is not the issue, though. As illustrated above, warehouses are bursting at the seams. Crops in producing nations, other than the US, are about the same size as in recent years.

The Indian monsoon has been above average. The USDA raised its estimate for Indian production by 1 million bales from its June estimate, to 28 million bales, or 5.6% higher than last year. The upward revision was possibly a reflection of the successful passing of the critical on-time arrival of the monsoon. The Chinese crop is down 1 million bales from last year, or 2.8%, but that is not very likely to result in increased imports – as explained below. A US crop failure – while, still a possibility – may not mean what it once did.

As with many commodities, Chinese import trends are the key. China's cotton stocks have ballooned to 59 million bales – having grown from only 10 million bales in 2010-11. The government is rumored to be poised to sell off inventories, and imports are expected to decline. In 2011-12, 54% of US exports went to China, compared with only 42% for the current marketing year.

Chinese imports from all sources peaked in 2011-12 at

24.5 million bales. In 2012-13 that figure fell to 20 million bales, and for the coming season, imports are expected to plummet to only 11 million bales. If China were to unleash its stocks, it would take a full season or perhaps two to see it return as a steady and reliable purchaser.

The flip side is that we do not actually know how large the stockpile is. The only solid information is the study of China's importing patterns. But as such, we may indeed be at the beginning of a period of greatly reduced Chinese imports.

US shipments for the outgoing 2012-13 marketing year have tapered off over the past four weeks, averaging only 160,000 bales. The July crop report cut the export estimate by 300,000 bales, to 13.3 million bales. But with only three weeks left to the marketing year, exporters would have to ship just under 300,000 bales per week to reach the USDA target, which is unlikely to occur. The USDA will have to cut its estimate again, which will increase the already-exhausting estimates for ending stocks.

We were stopped out of long position at 82.5¢ per pound, basis December, as per our May 8 recommendation. Massive global stockpiles will eventually find their way to the market and will depress prices. Establish short positions in December cotton. Place initial stops at 88¢, basis December, close only. *[**Sholom Sanik**, July 12, 2013]*

Chart 9 – December cotton

Courtesy Reuters

CORN

A soggy spring did not deter US farmers

It was widely expected that the USDA would slash its estimate for planted corn acreage in its June 12 monthly crop report. Although it would have been an unusual move for the USDA to do so between planting-intention reports – the next one was scheduled for release on June 28 – it was an unusually wet spring. Planting delays meant that farmers might not get into their fields before the seeding window in some regions would close. It was quite a surprise then when the USDA left the acreage estimate virtually unchanged from the May estimate, at 97.3 million acres. The bushel-per-acre (bpa) yield was lowered, but only marginally, by 1.5 bpa, to 156.5 bpa. If realized, that would put the crop at a record 14.005 billion bushels, topping 2009-10 output of 13.092 billion bushels.

It was more of the same in the July crop report. Traders were expecting some confirmation of compromised acreage and crop damage. The USDA actually *raised* the acreage estimate slightly. The abandonment rate was increased, but only by enough to bring the crop estimate down by a marginal amount, to 13.950 million bushels – which would still be a record crop.

In the meantime, December new-crop corn has been swinging back and forth to the tune of the latest forecast. Traders are now focused on forecasts for a couple of weeks down the road when the crop will enter the key pollination period.

The most recent weekly crop progress report put the good-to-excellent portion of the crop down two percentage points from the previous week, to 66%. That is still fairly high when compared with the five-year average of 61% and particularly comforting when compared with last year's disastrous 31%. An exceptionally hot stretch in the Midwest, however, has prompted private forecasters to cut their estimates even before the pollination period arrives. One estimate revised the crop down by 25 million bushels from the USDA July estimate. If that were the extent of it, then there is not much to worry about. There's still a long summer ahead, though.

On the demand side, US exports for 2012-13 reached only about one third of their normal level. It was not a reflection of world demand, though, but rather the simple fact that with such a small crop, there wasn't any more to sell. Ever since ethanol began to account for a significant percentage of corn usage, combined domestic feed and industrial usage consumed about 85% of output, with the balance going to the export market. In 2012-13 that figure rose to 97%, meaning that more than half the paltry amount that was sold overseas came from ending stocks.

As we wind down the 2012-13 marketing year, export commitments stand at a laughable 737 million bushels, against the USDA target of 700 million bushels. The average of the previous five years was close to two billion bushels. There are six weeks remaining in the marketing year. With shipments-to-date at 620 million bushels, we should just make the USDA forecast.

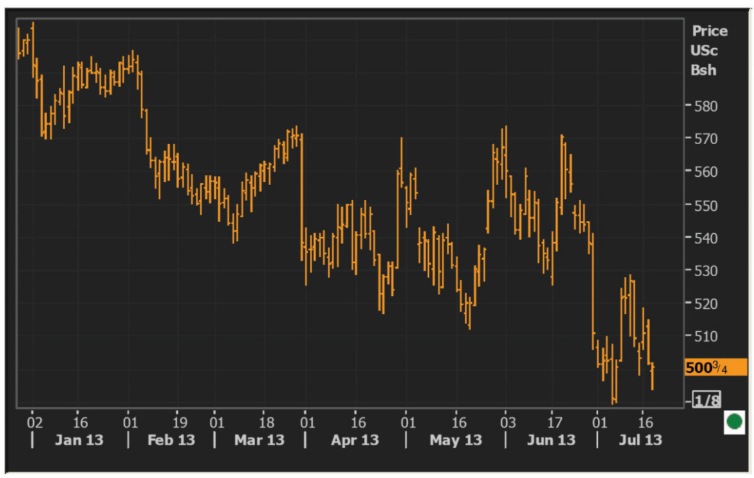
Looking ahead, advance export commitments for 2013-14 are about 300 million bushels, almost half of the entire current marketing year. That's at the high-end of the range for this time of year. So we're off to a decent start. The most recent weekly tally of more than 60 million bushels was larger than any single week in all of the 2012-13 season. So it would seem that foreign demand has at least stabilized.

Global ending stocks for 2013-14 are estimated at 16.2% of consumption. That compares with 14.3% for 2012-13, but represents no improvement over the five-year average. Strong demand will not be a surprise, though, because the USDA is already forecasting record global consumption that, if achieved, will be 11% higher than the five-year average. So it all comes down to the US crop. If the weather is favorable, we will see new-crop prices continue to drift lower.

We were stopped out of long position at $5.05 per bushel, as per our May 9 recommendation. From the case presented above, it would seem that a short position would be in order. We caution, however, that any glitch in the weather will be painful, so we prefer to stand aside for the moment.

*[**Sholom Sanik**, July 19, 2013]*

Chart 10 – December corn



Courtesy Reuters

CRUDE OIL

WTI reasserting its dominance

West Texas Intermediate crude oil in Cushing, OK has reasserted itself as a global benchmark for crude prices, having nearly closed the gap between the landlocked US delivery point and Brent crude oil, which serves as the benchmark for nearly half of the world's traded oil (Chart 11). The driver behind WTI's recent strength relative to its European counterpart is the growing use of railroads as a means of transporting oil to refineries on the East and Gulf coasts. Since the start of the year, oil deliveries by rail increased by 48% compared with the same period in 2012. Roughly 8% of all North American crude production is now transported by rail. The huge surge of investment on the part of the energy industry into increasing rail loading and offloading capacity has freed enormous quantities of light sweet oil from the Bakken shale, and is starting to ease the glut of supplies trapped in Cushing, OK.

As we discussed in a May 13, 2013, note entitled "WTI-Brent crude: moving oil to a new normal," the dramatic divergence between these two global benchmarks was the result of insufficient infrastructure in place to manage the exponential growth in crude production from unconventional domestic sources. With the widespread adoption of rail as an alternative to pipelines as a means to deliver crude to end users (refineries), not to mention the 37 other pipeline projects planned or underway in the United States, the congestion has been relieved and is unlikely to return. Going forward, and barring an incident in the Middle East that could disrupt energy markets, the spread between WTI and Brent should remain muted.

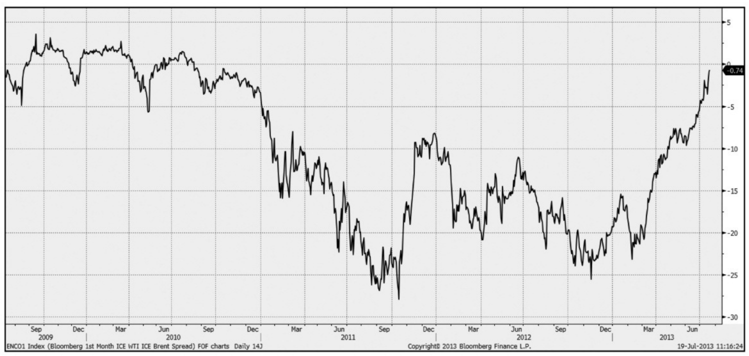
The retethering of the WTI benchmark to world oil prices accounts for a substantial portion of the recent rally in crude prices, which now sit at 15-month highs; however, strong seasonal demand from refiners has added to the upward pressure. Refiners ramp up their consumption of crude oil during the summer months to coincide with the summer driving season, which brings with it increased demand for gasoline and diesel.

The market is generally prepared for the increase in demand, and it is reflected in a slight seasonal tendency for crude oil to rise as spring turns to summer and weaken as the summer months wane. This year, however, the seasonal increase has been especially strong, due to increased overall production capacity, as well as newfound rail access to cheaper inland crude. US refiners are currently consuming more crude than they have at any time since 2005 (Chart 12). This has drawn down crude in storage by about 7.5% over the past two months, albeit from an all-time high.

These are relatively short-term factors, and the long-term outlook remains unchanged. Continued exploration of unconventional sources of domestic crude will lead to persistent domestic production increases in line with what has been experienced over the past few years (Chart 13). Be prepared to short WTI crude when seasonal support begins to fade.

*[**Jaime Macrae**, July 19, 2013]*

Chart 11 – WTI-Brent crude spread



Courtesy Bloomberg LP

Chart 12 – DOE total refinery crude inputs

Courtesy Bloomberg LP

Chart 13 – DOE domestic crude oil production

Courtesy Bloomberg LP

COCOA

Is there a bull lurking in the shadows?

Activity in the cocoa market has been somewhat enigmatic. Without the benefit of any obvious bullish fundamentals and in a generally weak commodity environment, it's surprising that prices have been relatively strong.

West African output for 2012-13 has been running ahead of last year and at a stronger pace than analysts had forecast earlier in the season. With the main crop season long over and the mid-crop currently in harvest, Ivory Coast port arrivals stand at 1.38 million tonnes, 6% above last year at this time.

Port arrivals in Ghana, the world's second-largest producer, are also well ahead of both last year and of expectations. Early forecasts put total output at 800,000 tonnes. By the end of May, arrivals had reached 750,000 tonnes, so it's a good bet that total production will reach 900,000 tonnes.

Nigeria's significance as a producer had been dwindling, but as a result of excellent precipitation this year, it will harvest a bumper crop of 280,000 tonnes, about 40% higher than in 2011-12.

Finally, in West Africa, Cameroon is maintaining its status as an up-and-coming producer with output expected to reach 230,000 tonnes, an improvement over last year's 220,000 tonnes and just shy of the record 240,000 tonnes harvested in 2010-11.

Output from the world's other significant producers, Indonesia, Brazil, and Ecuador, is steady at the levels achieved over the past couple of years.

While prices of many agricultural commodities have been fading back into pre-bull-market territory, there are two issues that have kept cocoa prices at their current levels.

Weather in the Ivory Coast has not been conducive for the early development of the coming 2013-14 main crop, which is harvested in October. Below-normal temperatures and inadequate sunshine hamper the proper setting of pods at this stage.

Coupled with the government's goal of protecting rain forests, output for the coming 2013-14 marketing year could suffer. A significant number of the country's most productive plantations are grown inside forest reserves, many of which the government claims are occupied illegally by cocoa farmers. Soldiers have been evicting the small farm communities. If the program is successful, we could see a meaningful decline in output – regardless of the weather. The government seems to be indifferent to the harm it may cause the industry because its agenda focuses on meeting European Union environmental standards.

Demand has also been helpful in keeping a firm tone in prices. Second quarter North American grind data, released on July 18, showed a 12% jump over year-over-year, much higher than expectations of 2% to 5% and the largest quarterly gain in three years. The European grind was up 6%, in line with expectations. But it was the first year-over-year increase since the fourth quarter of 2011. The Asian grind rose by only 2%, but first-quarter results were revised to a drop of 2% from a previously reported slide of 11%.

Butter ratios have been rising steadily and are now at 2.3 times the price of spot London beans. That's the highest level since 2009 and has provided an incentive for processors to buy beans for grinding. Although powder prices remain depressed, butter prices have been strong enough to lift the combined butter-powder ratio off its worst levels of the year (Chart 15).

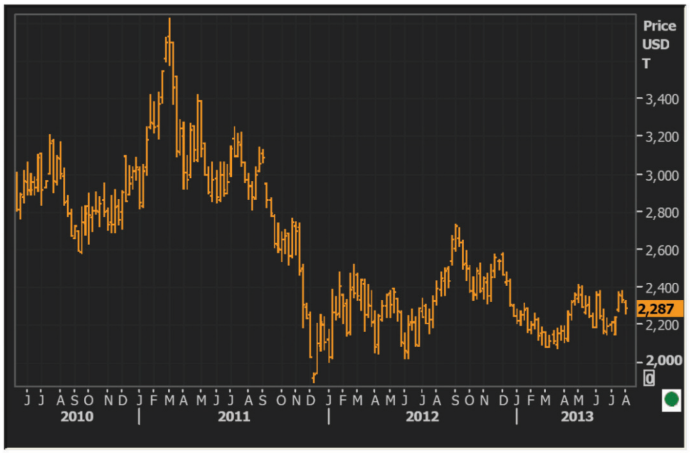
The current 2012-13 marketing year will end with a surplus, but as illustrated above, the following season could very well see the balance sheet slip into deficit. Early estimates call for a deficit of between 60,000 and 100,000 tonnes for 2013-14. The uncertainty surrounding next year's Ivorian production and the first indication in years that demand growth may outstrip output growth explain the market's resilience and leaves the market vulnerable to a more substantial deficit.

We believe the market is in the midst of a long-term bottoming process. Commodity funds are long the market, so a lot of buying power has already been spent (Chart 16). Establish long positions in December cocoa on setbacks. Place initial stops at $2,100 per tonne, close only.

*[**Sholom Sanik**, July 30, 2013]*

Correction: *In our most recent* Focus on Futures *article on cocoa (April 24) we discovered that we had unwittingly used faulty data to create the combined butter/powder chart. While the general idea of falling product values and the trend of the chart were both correct, the chart showed that the combined ratio had fallen to below 2 and to a new low. In fact it had fallen only to 3.5, and it was not a new low. We sincerely regret the error and apologize for any inconvenience it may have caused. [S.S.]*

Chart 14 – Weekly nearest contract cocoa



Courtesy Reuters

Chart 15 – Combined cocoa butter/powder ratio

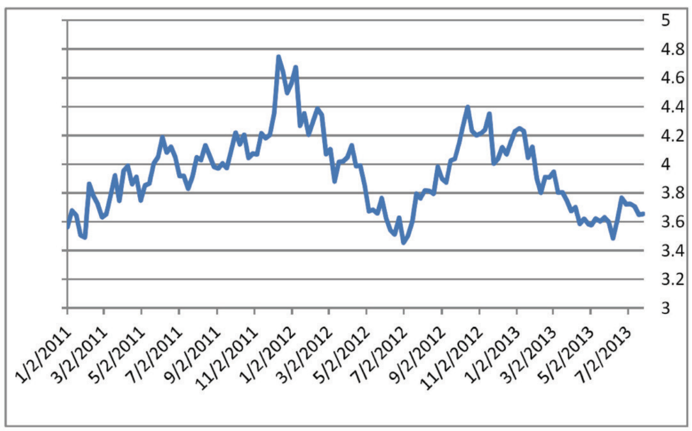
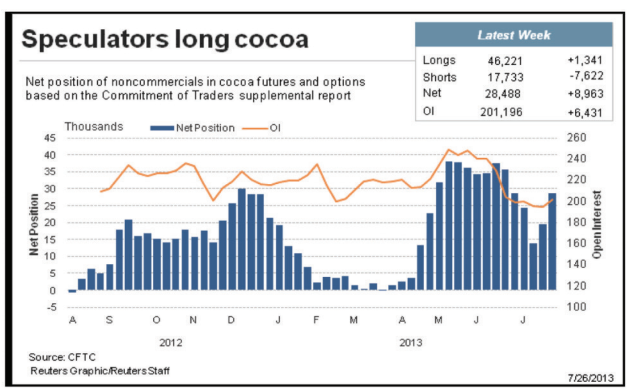


Chart 16 – Commodity funds net-long position



Courtesy Reuters

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