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Cocoa – looking to next year's Ivorian crop

There has been little in the way of fresh fundamental news in the cocoa market lately. The 2000-01 growing season is complete. The new crops in West Africa are on the trees, but it's far too early to expect accurate estimates of crop size.

The International Cocoa Organization (ICCO) published the most recent estimates of the 2000-01 production and consumption data. World cocoa production totaled 2.8 million tonnes, down 7.4% from the 1999-00 crop year. Grindings increased 1.5% from a year earlier, to 3 million tonnes, leaving a deficit of 200,000 tonnes. Ending stocks are expected to fall to 1.13 million tonnes, or 37.6% of consumption, compared with 44.9% at the end of 1999-00. This past season was definitely bullish, as the above data indicate, but that's old news. What lies in store for the future?

The most important issue is the 2001-02 Ivorian crop, which will be harvested starting in October. In 2000-01 the Ivory Coast produced 1.16 million tonnes, 17% less than the previous year. Even with the smaller crop in 2000-01, its output represented 40% of world production. Until we get a better look at the new crop, the market will be in doubt about whether the poor showing in 2000-01 was an anomaly after years of bumper crops or whether we have begun a trend.

In its July report, E.D.& F. Man was vague about next year's prospects, saying only that "overall, the crops in West Africa may prove to be sufficiently large next season to create a balance between supply and demand." There has been only one specific estimate, made by no specific analyst, but disseminated nevertheless on the news wires. It calls for a main-crop of 1.1 million tonnes. Assuming an average mid-crop of about 160,000 tonnes, this would put the total crop at 1.26 million tonnes.

Even with a 100,000 tonne increase in the Ivorian crop, the world production/consumption balance would not improve much. A mere 1% to 1.5% increase in grindings (30,000 to 50,000 tonnes) would still leave a deficit at the end of the 2001-02 season of about 150,000 tonnes. And none of the producing countries outside the West African region are going to pick up the slack. Man said in its July report that early crop development in Indonesia, the world's third largest producer, was well below average. In Brazil, a decade of falling production, caused by Witch's Broom disease, may have ended with a small increase in production of 4% for the 2000-01 season, as farmers gained some control over the debilitating fungus. Still, even an output increase in the neighborhood of 10% would add, at the most, 15,000 to 20,000 tonnes to the world balance, which would not change things all that much.

Second-quarter grind results were mixed. The Pan-European grind rose 1.7% over the same period last year, but the US grind was down 0.92%. The US liquor and butter melt, which don't make the headlines, but are a better indication of demand, rose 11.5% and 34% respectively. This reverses a trend in which the melt had been falling for several quarters.

Back in the Ivory Coast, the government is in the process of establishing a new private sector marketing board, but its mandate is not clear. Typically, a functioning marketing

In this issue

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board would be bearish for prices because farmers – knowing that they can sell their beans at some price – are more likely to invest in improving their crops. In addition, a forward sales program will put a cap on rallies, at least in the short term. This new marketing board, however, does not seem to have inspired much bearishness.

We continue to believe that the internal problems in the Ivory Coast that resulted in such a poor crop this past season have not gone away and could easily have the same effect on the 2001-02 crop. The political climate that has chased migrant workers out of the country has not changed. The government's efforts to ensure that farmers receive a fair price for their beans should be inspiring confidence among farmers, but it is not.

The current rally can be blamed on short covering by commodity funds, which were net short over 10,000 contracts before this leg of the rally began. A closer look, however, indicates that the era of abundance may be over for cocoa. During the years of the bear market, cocoa could be characterized by its large and persistent contango. Chart 1 shows that this rally has been accompanied by a sharp tightening of the 1-year spread, which in the absence of any other useful data, indicates clearly that demand is steady and that this market is running on more than short covering.

We missed this leg, but we remain friendly and looking to get in on the action. *[August 13, 2001]*

STRATEGY: *Stay tuned.*

Chart 1 – Cocoa Spread, December 2001 - December 2002

Courtesy REUTERS

CORN

Disappointing crops in the US and China are tightening up the corn market

The US is by far the world's largest producer and exporter of corn. It is expected to account for some 63% of world trade this season. All eyes are therefore on the progress of the 2001-02 crop, which has been hampered by hot and dry weather. Estimates for the size of this summer's crop have fallen by more than 300 million bushels from early season forecasts. In its August supply/demand situation report, the USDA estimated that the 2001-02 crop will yield only 9.266 billion bushels (235 million tonnes), down 7% from last season's near-record crop of 9.968 billion bushels (253 million tonnes).

The market rallied by as much as 50¢ per bushel from its early summer lows, before settling back into the mid-point of the season's range (Chart 2). As of this Monday's USDA crop progress report, the good-to-excellent portion of the crop stood at only 54%, compared with 64% on July 30 and 69% at this juncture last year. Despite the fact that crop conditions have deteriorated since late July, it seems that the market has discounted the damage caused by the poor weather and is groping for direction.

It is far too early to assume that the USDA's crop estimate is anywhere close to final. A number of private forecasters have a far more pessimistic view. The Professional Farmers Association of America reported on August 17 that its research calls for a US corn crop of only 9 to 9.12 billion bushels (228 to 231 million tonnes). The agriculture department at Kansas State University estimates the size of the crop to be between 8.46 and 8.95 billion bushels (214 and 227 million tonnes).

By using an average of private forecasters' estimates, we could expect the USDA to lower its crop forecast again in its September report by at least 300 million bushels. In this scenario, US ending stocks would fall to about 1.15 billion bushels, compared with the USDA's August estimates of 1.459 billion bushels, already slashed from the July estimate of 1.828 billion bushels. Expressed as a percentage of consumption, the carryover would be only 14.8%. Average ending stocks for the bear market years since 1997 ran at about 18% of consumption.

Looking at the global scene, we find that the USDA's 10 million tonne downward revision of its estimate of the Chinese crop far exceeds any upwards revisions to crops of some major exporters, such as the EU. After several seasons of playing exporter, China will merely be self sufficient in the 2001-02 crop year. With production of 105 million tonnes and consumption of 123 million tonnes, it will have a formidable deficit of 18 million tonnes, consequently drawing down its inventories.

Chinese carryover stocks at the end of 2001-02 are estimated at 62 million tonnes, or 50% of consumption. Although inventories seem high relative to the inventories of other countries, we believe that it is reasonable to expect that China will eventually be forced back to its traditional role of importer. Consider that ending stocks will have fallen 40 million tonnes, from 102 million tonnes, or 86% of consumption, at the end of 1999-00. In any event, the bearish effects of its fling as an exporter cannot last much longer.

The disappointing crops in the US and China have altered the world ending stocks picture dramatically. Even before making adjustments for the downward revisions to the US crop cited above, the USDA revised world ending stocks downward in its August report, to 124 million tonnes, or 20% of consumption. This compares with July's estimate of 141 million tonnes, or 23% of consumption, and last season's 156 million tonnes, or 26% of consumption. If the USDA revises the US crop again in September – as we expect it to – we are back to carryover of 18% consumption, not far from the tight situations that drove prices through the roof in the mid-1990s.

The supply picture as illustrated is very bullish, and is further underpinned by the demand side. The USDA has boldly projected that US exports will grow by 6.5%, to 51 million tonnes in 2001-02. Export sales of 650,000 tonnes this week were rather weak, but this comes after a summer of extraordinary business. Even after including this week's figure, sales of old and new crop combined averaged 1.27 million tonnes over the past 6 weeks.

Open interest levels are modest, having shed some 100,000 contracts since early this year. Commodity funds, however, are heavily long this market, with a net long position of 53,755 contracts, which is supportive while the market looks healthy, but becomes a negative when they begin to liquidate.

In conclusion, we believe that current prices do not yet reflect the lower forecasts for the US crop, and as such that the market is undervalued. *[August 24, 2001]*

CURRENT STRATEGY: *Remain long December corn as per Flash Update of August 23. Raise stops to 219, close only.*

Chart 2 – December Corn

Chart Courtesy *REUTERS*

GOLD

Looking up

There are many factors that affect the long-term direction of gold prices. They include the intensity of central bank sales and producer hedging. There is also the rate of inflation and, of course, the balance between mine production and physical and investment demand. Another of these determinants is the value of the US dollar.

Demand for gold is muted during periods of weakness in foreign currencies, which keeps gold prices weak. Traders and analysts are often bewildered when this relationship is not apparent in the short term. Over the longer term, though, the relationship is far more evident as depicted in Chart 3. Gold prices have fallen over $150 per ounce, or 40%, since February 1996. During this time, the US dollar, as measured by the dollar index, rose by 38%.

The protracted strength of the dollar has been somewhat puzzling, particularly since US stocks have been tumbling. A reallocation of assets requires selling of the local currency and should have depressed the dollar. A simple explanation cited by forex analysts is that the dollar remained strong because the economies in Europe and Japan have been crumbling simultaneously with the US economy, making their currencies no more attractive than the dollar.

We have come to a point, however, where the dollar may be far too overvalued. In some cases whole sectors of the US economy have been decimated, as noted many times in our discussions on the export markets of US agricultural products. The US current account deficit has grown precipitously during the five-year-old dollar bull market. The need to halt this trend may finally break the back of the dollar, which in turn should benefit gold prices.

But if gold will go up because of US dollar weakness, why not just be long the euro? Well, if the euro is going to appreciate merely because it is going to take over the status of the-lesser-of-two-evils currency from the dollar rather than on its own merit, gold may indeed be a better bet. Investors should eventually become frustrated in their search for currencies whose countries have sound economic fundamentals. Gold may once again become a safe haven, and the investment demand that will be generated will tip the scales in favor of gold.

While we are not offering any specific predictions about whether the dollar has finally topped, we believe that if the recent weakness in the dollar does continue and ushers in a bear market in the dollar, gold will draw disproportionate strength from that quarter.

On August 13 the World Gold Council reported that total global demand for gold fell 3% in the second quarter, to 764 tonnes, while jewelry consumption fell 2%, to 684 tonnes. It was particularly disappointing news to gold bulls that there was no follow-through from first-quarter results that showed solid gains in demand. At the time, that was an exciting development, because it seemed that gold consumption was bucking the trend. Consumer demand in most other areas was being affected negatively by faltering economies. Interestingly, gold prices rose in the days after the second-quarter results were released, despite its bearish implications. Gold prices seemed to be tracking the dollar.

The very small open interest, which on the surface seems to indicate that there is not a whole lot of interest in the gold market, is a bit deceptive. As of the last Commitments of Traders report, commodity funds are holding a net long position of 39,534 contracts. Small speculators are net long 24,878 contracts. The sentiment numbers we look at are running at two-year highs. Still, the market is not terribly overbought. The modest $10 per ounce drop of the past 2 weeks coincided with a drop of 12,000 contracts in the open interest. We believe that we are at the beginning of substantial rise in gold prices. *[August 31, 2001]*

STRATEGY: *Remain long December gold as per Flash update of July 9. Maintain stops at 255, close only.*

Chart 3 – Spot Gold (bar), Dollar Index (line)

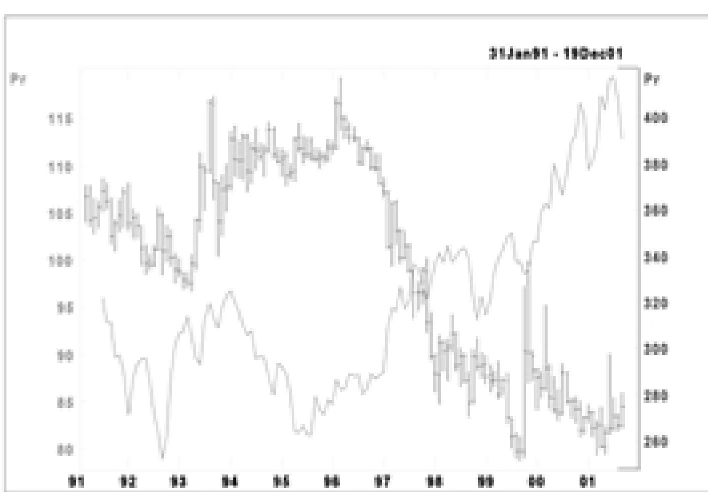

Chart Courtesy *REUTERS*

WHEAT

More of the same

Bullish fundamentals, but the downtrend lives on

Global wheat inventories continue to tighten. In its August supply/demand situation report, the USDA revised downward its forecast for ending stocks by just over 2 million tonnes, to 131 million tonnes, or 22% of consumption. This compares with ending stocks of 26% of consumption at the end of the 2000-01 season and 28% at the end of the 1999-00 season. Despite this, prices have once again retreated from a failed breakout. There has been no fresh bullish news in the past few weeks. If anything, the meager developments have been viewed by traders as negative for prices.

The Australian and Canadian crops are vital to the global wheat market. Although the two countries' crops together represent only about 8% of world production, their exports comprise more than 25% of world trade. Drought-like conditions plagued both countries this growing season.

The USDA estimated the Australian crop at 21.5 million tonnes in its August report, 300,000 tonnes larger than last year, but nowhere near the 25 million tonnes grown in 1999-00. Private forecasters' estimates were forecasting a crop that would be as low as 19.9 million tonnes. Recent rains were therefore very welcome to Australian farmers and have prompted some analysts to raise previous estimates by close to 500,000 tonnes.

The USDA lowered its estimate of the 2001-02 Canadian crop by 2.5 million tonnes from last month's estimate, to 22.5 million tonnes. This compares with last year's output of 26.8 million tonnes. On August 28, Statistics Canada cut its estimate to 21.5 million tonnes. Although the estimate came in at the low end of recent private forecasts of 21.5 to 23 million tonnes, it was well known that weather conditions were deteriorating. The market greeted this very important piece of information with a 4¢ per bushel selloff. By the end of the week, however, the market seemed to shake off these bearish developments and found its way back to the top of the recent range.

We are near the end of the growing season for the crops of the major exporters, and we have a fairly good idea of what the new supply situation will look like. The smallest US wheat crop in decades will draw stocks down to 16.76 million tonnes, or 26% of consumption, compared with ending stocks of 36% of consumption during the previous 4 years of falling prices. But the market has been well aware of this from the time early estimates of winter wheat seedings for the 2001-02 season became known almost a year ago. The health of the US export picture, then, becomes the most important variable in the market.

The USDA projects that US exports will remain fairly steady at 28.58 million tonnes, a tad lower than last year. The average weekly sales required to meet the USDA's target is about 550,000 tonnes per week. With 25% of the marketing year already in the books, net new commitments of 8.9 million tonnes are lagging last year's pace of 10.1 million tonnes. Recent activity has been adequate, though, with several weeks of above-average sales of 700,000 tonnes plus, compensating for the softer weeks. Better-than-average sales are the key to higher prices. The US dollar has fallen 6.6% since early summer, and this is certainly a factor that could affect the buying patterns of foreign purchasers of wheat as well as many other US-produced goods. Given tight world conditions, we feel confident that export sales will continue to improve.

Commodity funds were short this market most of this year. Although they've moved to the long side, at 3,402 contracts their net position is quite moderate, particularly when compared with much larger fund long positions in soybeans and corn. Small specs, on the other hand, have been long for most of the year, and it seems that they've been using this summer's rallies to liquidate. They are currently carrying a long position of 12,790 contracts, compared with over 20,000 contracts this past spring. Although the story of tight global wheat stocks is well worn in grain trading circles, we do not seem to have a burdensome speculative position. We remain friendly. *[August 31, 2001]*

STRATEGY: *Stay tuned.*

Chart 4 – December Wheat

Chart Courtesy *REUTERS*

HOTLINE UPDATE

Flash Update: **Thursday, August 2, 2001:**
Good afternoon for Thursday, August 2, 1:20 pm. This is a Flash Update. We have covered our short September crude oil position at 27.89.

Friday, August 3, 2001:
Good afternoon for Friday, August 3, 4:50 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop at 252; short September mini S&P, with our stop at 1230; and long September wheat, with our stop at 250. All stops are close only.

Friday, August 10, 2001:
Good afternoon for Friday, August 10, 4:50 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop at 252; short September mini S&P, with our stop at 1230; and long September wheat, with our stop revised to 261.5. All stops are close only.

Flash Update: **Wednesday, August 15, 2001:**
Good morning for Wednesday, August 15, 10:50 am. This is a Flash Update. We have liquidated our long September wheat position at 268.75.

Friday, August 17, 2001:
Good afternoon for Friday, August 17, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop revised to 255; and short September mini S&P, with our stop at 1230. All stops are close only.

Flash Update: **Thursday, August 23, 2001:**
Good morning for Thursday, August 23, 11:15 am. This is a Flash Update. We have purchased December corn at 226.5, placing our initial stop at 214, close only.

Friday, August 24, 2001:
Good afternoon for Friday, August 24, 4:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop at 255; short September mini S&P, with our stop at 1230; and long December corn, with our initial stop at 214. All stops are close only.

Friday, August 31, 2001:
Good afternoon for Friday, August 31, 3:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long December gold, with our stop at 255; short September mini S&P, with our stop at 1230; and long December corn, with our stop revised to 219. All stops are close only.

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