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Corn: the damage is done

"I don't really expect corn production to snap back." With this uncharacteristically candid prediction from the mouth of a bureaucrat, USDA chief economist Keith Collins pretty well summed up the bleak outlook for the US corn crop. The release of the August crop report confirmed that relentless drought in the US Midwest would lower yields dramatically. After considering the deterioration in crop conditions since last month's report, the USDA cut its yield estimate by 10 bushels per acre, to 125.2 bushels per acre. US output for 2002-03 is now estimated at 8.886 billion bushels (225.72 million tonnes), down 9.2% from last month's estimate.

Together with reductions in the Brazilian and Eastern European crop of 1.5 and 2.25 million tonnes respectively, the effect on the global supply/demand balance is extraordinary. Ending stocks will fall to 91.84 million tonnes from last month's 114.74-million-tonne estimate. The USDA has begun to factor in the rationing process by lowering its forecast for consumption by 5.71 million tonnes, to 621.17 million tonnes. Still, the loss of 1 billion bushels from the US crop is overwhelming and will draw global stocks down to 14.8% of consumption, compared with 18.3% in last month's report and 20.5% at the end of the 2001-02 season.

Any rain US crops receive from this point on will have a minimally positive effect on yields. Some analysts have suggested that the damage to the crop is comparable to that inflicted on the 1988-89 crop. We haven't seen any reliable analysts suggesting that we will have a yield quite as low as the 84.6 bushels per acre harvested in the 1988-89 season. However, the USDA's 125.2 bushels per acre is still on the high side when compared with other summers that received as little precipitation as we did this year.

We are assuming that the USDA is still taking a cautious approach just in case we see optimum weather conditions from now through harvest. Indeed, recent estimates seem to use 125 bushels per acre as the high end of the range. A further, even modest, reduction to, say, 120 bushels per acre, using current acreage estimates (which could also prove to be on the optimistic side) would give us a crop of only 8.52 million bushels (216.4 million tonnes), drawing global endings stocks down to 82.52 million tonnes, or 13.3% of consumption.

There is much discussion about growing Chinese output and the amount of corn China will have available for export. In fact, the Chinese have been doing a fair amount of business with their Asian neighbors, but the USDA has accounted for this by raising its estimate of Chinese exports by 2 million tonnes over last month's report, to 8 million tonnes. Still, the loss of 23 million tonnes of output from the world's largest producer and exporter certainly overwhelms any inroads the Chinese have made into the corn export market.

As we pointed out above, demand is elastic, and we can expect some sticker shock to prevail at some point. This past week's US export report, however, was surprisingly strong, with combined old crop and new crop sales totaling 1.3 million tonnes, significantly above the 828,000-tonne average of the previous 4 weeks.

As solid as the bullish fundamentals are, the buildup in the open interest should be somewhat disquieting for bulls. Since the market bottomed in mid-April, the open interest has

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Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

jumped by 133,000 contracts, to 528,000 contracts, a whopping 25% increase. Both commodity funds and small speculators have been doing the buying.

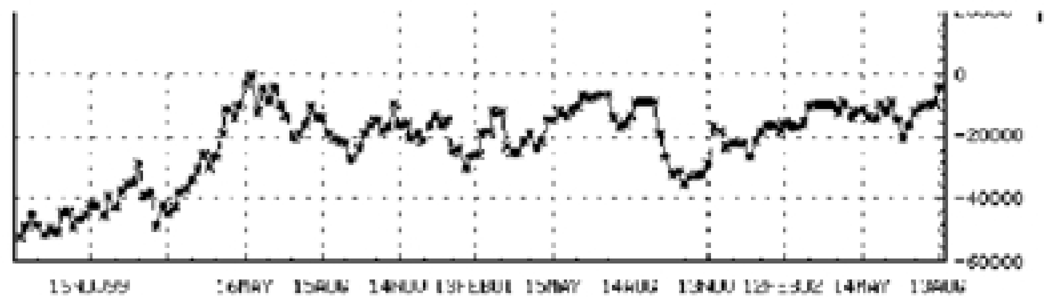
A closer look, however, at the composition of the open interest through the commitment of traders data shows that the speculative long positions may not be quite so burdensome. First of all, small specs came into this drought non-believers and heavily net-short (Chart 1). As matter of fact, even after all the buying, the group is still net short 4,472 contracts. Then, the size of commodity funds' net-long position is roughly the same size it was during bear market rallies in the spring of 2000 and late 2000/early 2001 (Chart 2).

Typically, the problem with ballooning open interest for a bullish speculator in a rising market is that commercial sellers (the production community) have positioned themselves with short hedges and can outlast the speculator because they can make physical delivery. The decision to hedge may not have been the correct one, and they may well be missing out on a glorious bull market, but they have staying power. If the US crop continues to deteriorate, however, commercial users (feed lot operators) will become the buying group and a massive short-covering rally will ensue, bringing even higher prices. This is similar to what happened in the cocoa market, the subject of an article to be published later this month.

We acknowledge that the technically overbought conditions have made us a bit uncomfortable, but we believe that if the global supply/demand balance continues to tighten, the market will work off the overbought conditions by means of relatively painless sideways action. *[August 20, 2002]*

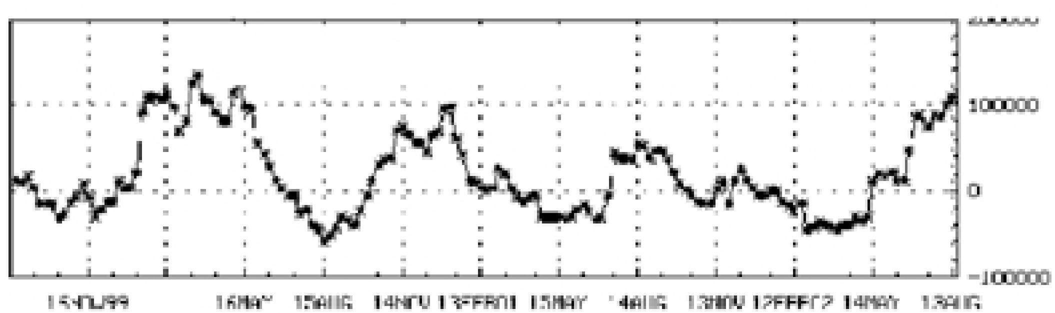
STRATEGY: *Remain long December corn, raise stops to 243, close only.*

Chart 1 – Small spec net position



Courtesy Bloomberg LP

Chart 2 – Commodity fund net position



Courtesy Bloomberg LP

SOYBEANS

How much have recent rains helped the stressed soybean crop?

Soybean prices pulled back sharply over the past week – by about 8% – in response to the arrival of friendlier weather across the various US growing regions. Monday night's weekly USDA crop progress report confirmed that conditions had improved with recent rains. The good-to-excellent category moved up 2 percentage points from the previous week, to 44%, but was still well below last year's 52% at this juncture of the season. More importantly, unlike the corn crop, which can no longer benefit from the precipitation, the soybean crop can still be saved and return to trendline yields.

On Friday morning, *Pro Farmer* will report the results of its crop tour. Comments from the scouts seem to indicate that there definitely has been an improvement in some areas, but that some regions are probably beyond relief from wetter conditions.

While the effect the drought in the US will have on the 2002-03 crop is clearly the primary issue for this market, it is not the only bullish aspect. The revisions to last month's data were not insignificant. In its monthly supply/demand situation report, the USDA cut US 2001-02 ending stocks by yet another15 million bushels from its July estimate, to 195 million bushels. This works out to 6.6% of consumption, compared with 8.8% at the end of 2000-01.

We are entering the 2002-03 marketing year with the lowest carryout since the 1996-97 season, when stocks were 5.4% of consumption, a period in which beans skyrocketed to $9 per bushel. With the final crop estimate for 2001-02 long in the books, the consistent downward revisions to ending stocks – estimated to be as high as 270 million bushels earlier in the season – has been the result of increased demand from both the domestic crush and exports.

In China, domestic prices for soyoil and meal have risen, with the bean market making crush margins very profitable. Demand for imports is especially strong, because the country ran down its inventories during the period that the government was imposing new guidelines for allowing GMO beans into the country. As a result, we can expect Chinese demand to remain robust.

As for the US crop, analysts are still working with the USDA's yield estimate of 36.5 bushel per acre. There have been instances in which yield estimates changed enough from the August estimate to alter the picture significantly. Considering the extent of this year's drought, however, it is reasonable to assume that the yield would have difficulty climbing more than 1 bushel per acre from the USDA's 36.5 bushel-per-acre estimate. At 37.5 bushels per acre, the US crop would reach 2.7 billion bushels, an increase of 72 million bushels from the USDA's 2.628 billion bushels (2 million tonnes), bringing ending stocks up to only 227 million bushels, or 8.5 % of consumption.

Plugging a 2-million-tonne increase of the US crop into the global balance sheet would barely create a ripple in the bullish case. Consumption is forecast to grow by 6 million tonnes this year, leaving ending stocks at 24.9 million tonnes, still 5 million tonnes below last year's level, or 13% of consumption, compared with the current estimate of 12% and last season's 16.4%.

The drop in November beans earlier this month, down to the $520 per bushel level, saw open interest shed some 30,000 contracts, which did not return on the post-crop-report rally. Although the commitment data show that both commodity funds and small speculators are heavily net-long (48,597 and 17,367 contracts respectively), it should be comforting for bulls to know that the problem was not exacerbated on the runup to the $5.80 per bushel level.

In conclusion, the risk for bulls is that the precipitation over the past few weeks has been beneficial enough for a return to normal yields. On the other hand, steady consumption growth has tightened global supply/demand balances over the past few years. The potential for a disastrous US crop has the potential of completely overwhelming any gains from the huge South American crops. The risk/reward ratio favors the reward side. We waited patiently for an opportunity to enter the long side, and we believe that this is it.

[August 21, 2002]

STRATEGY: *Buy November soybeans at the market, as per Flash Update of August 21. Place initial stops at 499, close only.*

COPPER

What's wrong with the copper market?

The direction of copper prices and equity indexes has long been viewed by market participants as a leading indicator of economic activity. The extent to which the two move in the same direction has been considered an even more reliable forecasting tool. During periods of uncertainty – such as the current environment in which much debate exists on whether we will "double dip" or not – the market pays particular attention to this relationship (Chart 3).

After moving almost in lockstep from May through early August, copper did not fully participate in the powerful 24% rally stocks have enjoyed. Even after a bounce off recent lows, copper prices languish in the sub-70¢-per-pound area. Certainly in terms of the 60¢-90¢-per-pound range of the past 3 years, copper prices are weak.

The massive producer cutbacks announced late last year sparked a strong rally last November, which fizzled earlier this summer. The supply/demand balance has improved, but not enough to keep the market from retracing two thirds of those gains. In its August report, The International Copper Study Group (ICSG) estimated that although the market has now recorded two consecutive months of small production/consumption deficits, we are still running a surplus, year to date. Production of refined copper from January through May was 6.435 million tonnes, 1.1% more than the same period last year. Consumption, on the other hand, was 6.268 million tonnes, 0.07% below the previous year, leaving a production/consumption surplus of 167,000 tonnes.

Bulls banked on economic recovery that would eventually translate into industrial demand. Combined with the output curtailments, it was assumed that by this stage of the recovery, copper prices would perform the way other industrial commodities such as cotton and petroleum have. Copper has been one of the star laggards among commodities, as depicted in Chart 4.

There is no enigma here, though. The fundamentals of the commodities that have been strong have improved significantly. A look at the primary economic indicators directly tied to copper consumption are a mixed bag. US industrial production has grown steadily this year, recording a 0.2% gain in July after much stronger gains of 0.7% and 0.5% for the previous 2 months. Industrial production in the Eurozone, however, is still contracting by about 1% per month, albeit at a smaller rate than earlier this year.

US housing starts, which were inflated as a result of the NASDAQ-bubble economy, have had back-to-back months of 2.7% declines.

The production picture in Chile – the world's largest producer – has been friendly to the bull case. Mine output for June was up 0.6% over last June, but that was preceded by 3 months of hefty declines of 3.3%, 5.2%, and 3%. The most recent statistic out of Chile is consistent with the major trend. July output at the huge Escondida mine was down 23.4%.

LME warehouse stocks have backed off their highs, but remain stubbornly high at 892,500 tonnes. Same goes for Shanghai at 201,963 tonnes and New York at 375,516 tonnes.

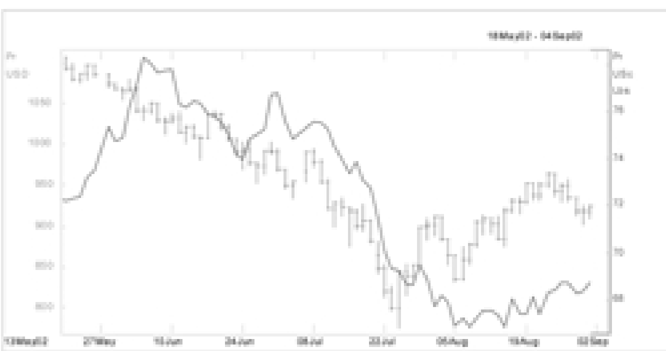
Although the fundamentals are not that bullish, they're not that bearish either. In light of the optimism displayed in the equity markets, copper seems to be underpriced in terms of its historical status as a harbinger of future economic activity and the slowly improving fundamentals.

The bulging open interest tells a big part of the story. The commodity funds have attacked the short side with a vengeance. At 103,430 contracts, open interest has never been this high. According to the most recent CFTC data, the funds added to their already large position to make them net short 17,395 contracts. From a technical standpoint, the shorts have run out of steam in that the most recent addition to open interest has not been able to push the market through the lows.

In conclusion, the speculative selling may very well be keeping copper prices at bay. As such, we could expect a strong rally at some point. Still, it would trigger a broader and sustainable bull run only if the surpluses were to disappear. For the moment, we're on the sidelines, but with an open mind. *[August 30, 2002]*

STRATEGY: *Remain sidelined.*

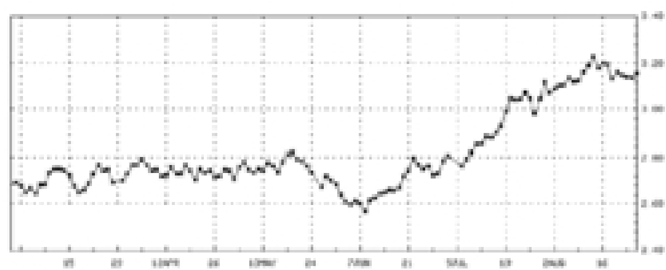
Chart 3 – Copper, S&P 500



Copper (line), S&P 500 (bar)

Courtesy Reuters

Chart 4 – CRB Index/Copper



Courtesy Bloomberg LP

COCOA

Any juice left in cocoa?

The bull market that has just about tripled the price of a tonne of cocoa happened as a result of stagnant growth in output. It certainly had little to do with the demand side, because grindings have been shrinking, quarter after quarter. You'd think, then, when bearish production data began to cross the wires, the market would embark on a correction of some degree. That's not the way events have unfolded, though, with December cocoa having sprinted past the $2,000-per-tonne mark, a level not seen in 15 years.

Talk is that both the Ivorian and Ghanian 2002-03 crops will be bigger than last season. There is not much in the way of specific numbers, but the bull market prices farmers have been receiving for their beans seems to have allowed them to purchase and apply more fertilizer and pesticides than they have in years.

While these loose forecasts for higher production have been making the rounds, E.D.&F. Man has been mysteriously absent from the scene. Typically, the commodity firm, probably the most reliable crop forecaster for soft commodities, has one and sometimes two summer reports. Last year, Man provided an early snapshot of the 2001-02 Ivorian main crop in July. We keep hearing that it will be releasing a production estimate in a few days, but we've heard that several times. We draw your attention to this because at this time of year, the release of Man's data is the most important event to be looking for, for those who follow this market.

In any case, market action, if anything, would seem to indicate that the crop will not be any bigger than last season's. The only numbers we've seen for the Ivorian crop are anonymous estimates for a main crop of not greater than 1 million tonnes. This would be about 50,000 tonnes smaller than last year's main crop. We will not, however, give much credence to any estimate until we see what Man has to say.

On the consumption side, the gauges are mixed. On the one hand, the spreads in both New York and London are quietly making their way back to contango. This indicates that the groups who were doing the urgent buying – commercial users or squeeze-play speculators in London – have completed their purchasing programs for the moment. On the other hand, butter ratios have been firming. Weak processing margins were understood to be the primary reason for the weak grindings we've been seeing. If press reports that are saying that butter inventories have been reduced significantly are accurate, we could expect grinding activity start to pick up again. Global butter inventories stand at about 60,000 tonnes, down from 120,000 tonnes late last year.

The International Cocoa Organization (ICCO) recently revised is supply/demand estimate for 2001-02. It said that global output fell by 0.6%, to 2.807 million tonnes, while grindings declined by 6.3%, to 2.859 million tonnes. Although this leaves a deficit of 80,000 tonnes, it is a downwards revision from the ICCO's previous forecast for a deficit of 130,000 tonnes.

So, aside from the butter stocks item, which doesn't capture many headlines, the news has been mostly negative, but prices keep rising.

Most impressive and encouraging for bulls who have stayed the course is the composition of the open interest, which indicates that the bull run in cocoa prices has not been the result of a speculative bubble. The most recent CFTC data show that commodity funds actually increased their net-short position by 712 contracts to make them net short 6,601 contracts. Small specs increased their modest net-long position by 414 contracts to make them net long only 2,258 contracts.

Chart 6 shows clearly how the small spec community never bought the story and has stayed away from this market. The significance of this is twofold. First, the strength in the market is a result of commercial buying, which does not seem to be letting up. In addition, there are few stops to run, which should make any counter-trend moves orderly and short lived – a very useful bit of information for a bull looking for a spot to buy cocoa (or for a hurting bear looking to accept his lumps).

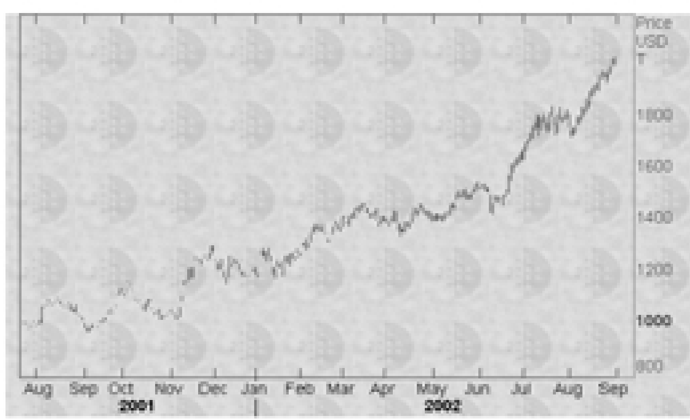
If we begin to see serious estimates for the Ivorian main-crop around 1 million tonnes, even a very decent mid-crop of 200,000 tonnes would leave the total crop smaller than the 2001-02 crop and set up another deficit year. If grindings do indeed begin to creep back up, we will be looking at a global stock level below 30% of consumption, the magic number for this most vulnerable commodity.

Having been so bullish, but having been frightened away by some minor bearish open interest signals months ago, we must admit that we're feeling a bit silly. We wait patiently for an opportunity to consider the long side once more.

[September 1, 2002]

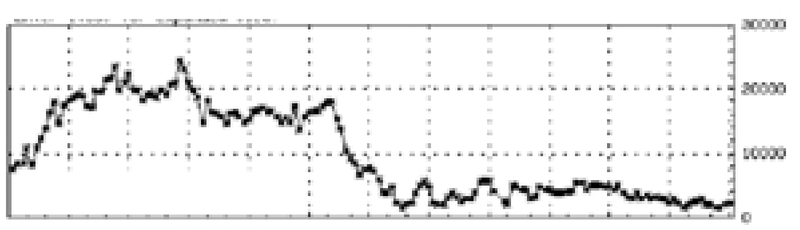
STRATEGY: *Remain sidelined.*

Chart 5 – December cocoa



Courtesy Reuters

Chart 6
Small speculators net-long position



Courtesy Bloomberg

HOTLINE UPDATE

***Flash Update* – Monday July 29, 2002:**
Good afternoon for Monday, July 29, 4:15 pm. This is a Flash Update. We have covered our short September mini S&P at 896.

***Flash Update* – Friday, August 2, 2002:**
Good morning for Friday, August 2, 9:10 am. This is a Flash Update. We have purchased December gold at 306.20, placing our initial stop at 290, close only. We have also sold short September mini S&P at 884, placing our initial stop at 915, close only.

Friday, August 2, 2002:
Good afternoon for Friday, August 2, 5:05 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December corn, with our stop at 228; long December wheat, with our stop at 302; long December gold, with our initial stop at 290; and short September mini S&P, with our initial stop at 915. All stops are close only.

Thursday, August 8, 2002:
Good afternoon for Thursday, August 8, 9:00 am. We have covered our short September mini S&P position at 878.

Friday, August 9, 2002:
Good afternoon for Friday, August 9, 4:35 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December corn, with our stop at 228; long December wheat, with our stop at 302; and long December gold, with our stop revised to 300. All stops are close only.

***Flash Update* – Tuesday, August 13, 2002:**
Good afternoon for Tuesday, August 13, 4:05 pm. This is a Flash Update. We have sold short September mini S&P at 882.75, placing our initial stop at 915, close only.

***Flash Update* – Wednesday, August 14, 2002:**
Good afternoon for Wednesday, August 14, 4:15 pm. This is a Flash Update. We have covered our September mini S&P at 918.25.

Friday, August 16, 2002:
Good afternoon for Friday August 16, 4:25 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December corn, with our stop at 228; long December wheat, with our stop at 302; and long December gold, with our stop at 300. All stops are close only.

Wednesday, August 21, 2002:
Good morning for Wednesday, August 21, 10:55 am. We have purchased November soybeans at 540, placing our initial stop at 499, close only.

Friday, August 23, 2002:
Good afternoon for Friday, August 23, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December corn, with our stop revised to 243; long December wheat, with our stop revised to 325; long December gold, with our stop at 300; and long November soybeans, with our initial stop at 499. All stops are close only.

Friday, August 30, 2002:
Good morning for Friday, August 30, 9:15 am. We have sold short September mini S&P at 915, placing our initial stop at 970, close only.

Friday, August 30, 2002:
Good afternoon for Friday, August 30, 5:05 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December corn, with our stop at 243; long December wheat, with our stop at 325; long December gold, with our stop at 300; long November soybeans, with our stop at 499; and short September mini S&P, with our initial stop at 970. All stops are close only.

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