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The US corn crop disappoints

Corn prices had already been moving off one-year lows when the USDA weighed in with its monthly supply/demand situation report on Aug. 12. Until late-July/early-August, the US corn crop was cruising along, on its way to a record crop. Prices fell precipitously. Hot and dry weather across the US corn belt, however, was causing crop conditions to deteriorate. The good-to-excellent portion of the crop peaked at 74% on July 21 and has been lower in each weekly reporting period since. This premium segment now represents only 50% of the crop as of Monday night's crop-progress report, a dramatic shift in the fortunes of this year's crop!

The monthly USDA report confirmed that the crop was not as large as earlier believed. Analysts were considerably off the mark with this one, which added to the bullish tone. Yields were lowered by close to 3 bushels per acre, to 139.9 bushels per acre, resulting in a revised crop forecast of 255.65 million tonnes (10.064 billion bushels), over 5 million tonnes below last month's estimate. Analysts were actually looking for a higher estimate, with the average guesstimate at 262 million tonnes (10.319 million bushels).

With the size of the US crop almost certain to be revised downwards again in the September monthly report, it is now clear that the market mispriced corn when it was down at the $210-per-bushel area.

The impact of a lower US crop at the global level was significant, particularly because there were other downward revisions for 2003-04 production – for the EU and Eastern Europe. In total, global production was revised downwards by 11 million tonnes from the July estimate. Consumption was also lowered by close to 3 million tonnes, resulting in a 7-million-tonne drop in global ending stocks. At 78.66 million tonnes, ending stocks are now 12.4% of consumption, down from 13.4% last month, and compared with 15.5% in 2002-03 and 20.7% in 2001-02.

While the market's bullish reaction was well warranted, we should bear in mind that the bullish developments are all on the supply side. To sustain the rally, the demand side will have to develop. The US export picture is reasonable, but not that exciting. The USDA revised 2003-04 exports downwards by 1.27 million tonnes in the August report, to 45.72 million tonnes. While exports are expected to be much higher than the dismal 2002-03 performance of 40.64 million tonnes, they remain below the 5-year average of 47.5 million tonnes.

This week's new crop commitments of 950,00 tonnes were the biggest number of the young season and an encouraging development. Commitments for the previous 4 weeks averaged 591,000 tonnes. Year-to-date new-crop commitments stand at 4.878 million tonnes, below last year's commitments of 5.210 million tonnes at this early juncture of the season. While it is indeed early, the sluggish start to the season does not bode well, especially since this is slated to be a recovery year for exports. But again, it is premature to judge exports by August 2003 results for a marketing year that runs until Aug. 31, 2004.

Although evidence of improved demand in the form of stronger exports would be useful for the bull case, we do believe that demand will appear – from Asia specifically – just as it did for soybeans. The very same hog and poultry population that caused the explosive growth in protein-feed demand needs its carbohydrate feed as well. As we pointed out in our June 26 issue, carbohydrate demand was supplemented by much-larger-than-normal FSU feed-wheat crops last season. The total FSU wheat crop is expected to be a staggering 37% smaller than it was in 2002-03 (We'll expound on the figures

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in a broader discussion on wheat later this month).

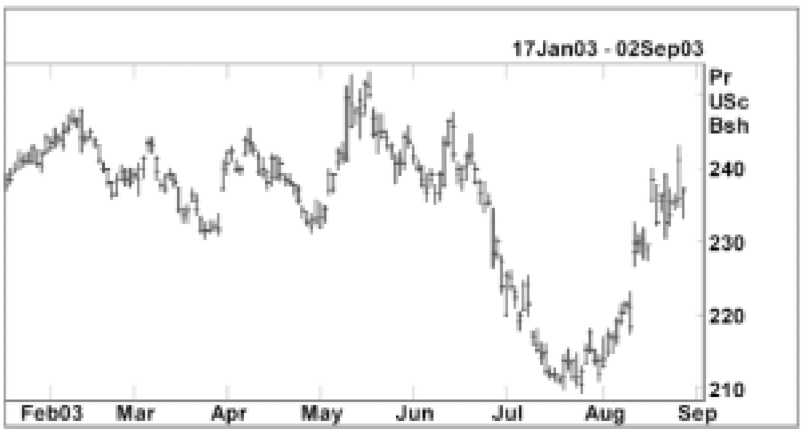
The process of short covering by commodity funds, which we were confident would show up sooner or later, is almost complete. As of this past week's Commitment of Traders report, the funds covered an additional 28,874 contracts to leave them net-short just over 9,000 contracts, compared with their net-short position of 68,936 at the bottom of the market. It is important, then, for the market to start making upside progress, or we will have to consider the possibility that the rally was only strong enough to take the shorts out.

We are not concerned about weak-handed longs having extended the rally to overbought conditions, because all the sentiment indicators we monitor indicate that bullish sentiment is muted. The street is not enticed by the story.

In conclusion, low levels of global ending stocks make this market vulnerable. The two key items to monitor are the progress of the US crop and US exports. The former has already gratified bulls, and we believe that the latter will kick in as the season progresses. The market has paused to consolidate the gains, but should break through to the upside in short order. *[August 28, 2003]*

CURRENT STRATEGY: *Remain long December corn. Raise stops to 220, close only.*

Chart 1 – December corn



Courtesy Reuters

WHEAT

The wheat market enters its sixth year of declining production

For us, any discussion of wheat would be incomplete without some mention of how we – resolute bulls – missed a close-to-$1-per-bushel rally. We've been touting the bullish fundamentals of wheat for several years now and yet failed to recognize a glorious buying opportunity that appeared early this summer.

The meat of the bullish case has not really changed very much. Global output continues to fall while consumption remains steady. The market entered this season in an already-vulnerable position, and then Murphy's law kicked in. The 2003-04 season will now mark the sixth consecutive year of lower global production.

The USDA's August supply/demand situation report contained significant revisions to production that reflect crop losses resulting from the hot and dry growing conditions in key growing/exporting countries. A heat wave swept across Europe, prompting the USDA to slash its output forecast for the EU by 5 million tonnes, to 94.5 million tonnes from its July estimate, and down from 2002-03 output of 103.32 million tonnes. A revised 93.09-million-tonne estimate was released today by the EC that accounts for the more recent weather-related impact on the crop.

Drought conditions will reduce the Canadian crop as well. This was expected to be a bounce-back year for Canadian wheat after the 2002-03 crop was also ravaged by drought, yielding only 15.7 million tonnes, about 25% below the 2001-02 crop. The USDA pegged the 2003-04 Canadian crop at 22 million tonnes, but a recent Statistics Canada estimate has lowered that forecast to 20.96 million tonnes.

The Eastern European crop was revised lower again by 2.73 million tonnes from the July estimate, to 22.2 million tonnes, down more than 8 million tonnes from 2002-03.

By far, the most dramatic crop failure was in the FSU. A 1.2-million-tonne downward revision brings total FSU output down to 60.98 million tonnes, a 36.8% drop from 2002-03. Exports are expected to fall by over 15 million tonnes.

Taking into account the updated crop estimates for Canada and the EU, global production will shrink by 16 million tonnes, or 2.8%, from 2002-03, to 546.9 million tonnes. This will be the smallest crop since the 1995-96 season.

The USDA also lowered its estimate for global demand by 1.25 million tonnes from last month, to 582.87 million tonnes, which will be 13.26 million tonnes below last year's consumption. But inventories have been run down year after year with production/consumption deficits. Last year the gap was 33.09 million tonnes. This season, even with lower consumption, the production/consumption deficit will deplete carryover stocks by a further 35.82 million tonnes. Ending stocks will fall to 128.1 million tonnes, or 22% of consumption, compared with 27.5% in 2002-03 and 33.7% in 2001-02. You'd have to go back to the 1971-72 season to find carryover stocks at these levels. Those low inventories in the early 1970s ushered in a bull market that took wheat prices to $6 per bushel.

The USDA is looking for US exporters to compensate for the smaller crops of other major exporters. The estimate for 2003-04 exports was raised by 2 million tonnes from last month, to 28.58 million tonnes, 5 million tonnes better than 2002-03. Two months into the marketing year, commitments stand at 10.85 million tonnes, 2.3 million tonnes above last year at this time.

This week's commitments of 1.286 million tonnes were extraordinary. Analysts were expecting a good number (800,000 tonnes), but this was well above the norm for wheat. There was a large sale of 320,000 tonnes to Nigeria, but even without that sale it was an above-average figure. The buying was widespread, with sales to Asian, African, European, and Latin American destinations. And of course, herein lies the key to maintaining this bull run. If demand remains strong, already tight inventories will be pressured, and prices will continue to rise.

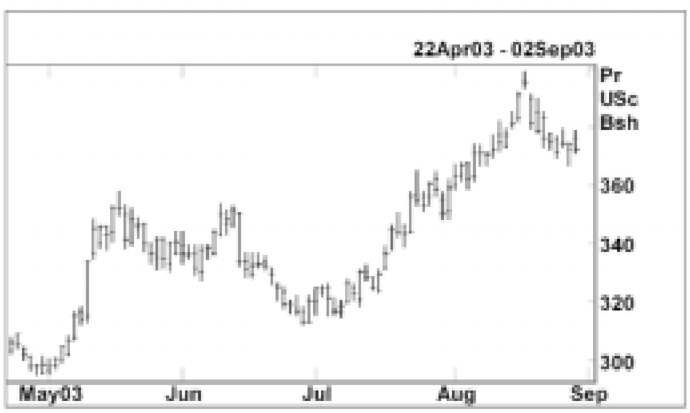
For the moment, the market is probably a tad overbought. Even for those fundamentally inclined it may pay to take note of a classic bearish technical signal that was triggered just as the market attempted to cross the $4-per-bushel level. There was an "island reversal," an indication of frenzied activity at a market extreme at an unsustainable price level (Chart 2). Commodity funds have already established a net-long position of 35,000 contracts, a marked contrast to corn and beans, where funds are just climbing out of their short positions.

Still, we maintain a strong bullish bias. The market is catching up with complacent consumers. Any assistance from the demand side should easily be able to take the market past the 2002 high of $4.40 per bushel. We'll be back.

[August 28, 2003]

STRATEGY: *Stay closely tuned.*

Chart 2 – December wheat



Courtesy Reuters

COCOA

Cocoa prices back to the highs? Don't count on it

To be sure, there are a number of concrete bullish factors affecting the cocoa market that – on the surface – make the current rally seem well warranted.

Ivorian production for the 2002-03 season, and more significantly, delivery of the crop (harvesting, delivery to port, and shipping) did not simply muddle through the civil war. They came through with flying colors (more on that later). Still, concerns exist that migrant workers from neighboring African countries will be scouring the help-wanted pages for a safer line of work. Apparently, imported labor is key to growing, harvesting, and delivering a full-size cocoa crop in the Ivory Coast.

Although we know of no crop in the history of commodity trading that has not been threatened by a meteorologist at some point in its seeding, growing, or harvest stages, the dry weather in West Africa does seem to have serious implications, if there is no improvement. To date, rainfall is reportedly only 20% of normal for this time of year.

Second-quarter grind results were positive across the board, both in Europe and the US, and that pattern is expected to continue. Grinding activity is forecast by several analysts to grow by 3% to 3.5% in the 2003-04 season. Given a scenario in which global output will grow only slightly, to just over 3 million tonnes, because of a smaller Ivorian crop, we will return to a production/consumption deficit, of between 50,000 and 100,000 tonnes. Ending stocks would be about 34% of consumption, compared with 38% for 2002-03, a level that will inspire enough nervousness to give bulls an edge.

The first three months of New York remain in backwardation, and warehouse stocks, in both New York and London, have been falling. Butter ratios in all grinding regions seem to be holding at the high end of the range – close to two times the price of LIFFE futures. All indications of tightness.

So why does it sound like we're not sold on the bullish case?

Arrivals at Ivorian ports reached 1.33 million tonnes as of August 10, with more mid-crop beans still to come. Any ideas that the civil strife in that country was going to affect growing or delivering the crop have faded. It's rather amazing that a near-record crop was turned out when we spent months believing that crop would be no larger than perhaps 900,000 tonnes. Whoever is running the Ivory Coast – the government, rebels, foreigners? – obviously have not allowed the knowledge that cocoa exports are absolutely vital to the country's economy to slip by their desk. Why should we expect that to change when no evidence exists that the cocoa industry will be hampered in any way? Yes, the fact that this country is the source of 40% of the world's supply, and that supply-interruption risks do exist, does merit a premium. And yes, the bulk of the balance of cocoa beans grown in the world hails from other unstable regions.

But current price levels represent far more than a mere premium. Even after a substantial drop from the $2,400-per-tonne peak, prices are 250% above the level from which this bull market began two and a half years ago. True, the fundamentals have definitely changed in terms of global ending stocks. We went from inventories of close to 50% of consumption to the mid-30% range, and we are now entering the fourth season in which ending stocks are still falling, albeit modestly.

The rich prices have, however, had a very fundamental impact on the market. As we mentioned in past issues, farmers in cocoa growing countries, after years of suffering through low prices, are actually earning profits and are spending some of their money on pesticides and other crop enhancing tools. In a scenario in which the Ivory Coast equals last year's crop and optimistic grinding forecasts are not met, we're right back to the 40% of consumption range.

Aside from the problem in Indonesia, which trimmed anywhere from 50,000 to 75,000 tonnes from the 2002-03 crop, other regions are showing signs of responding to high prices with larger crops and may be able to compensate for weather related losses in West Africa.

Malaysia – once a prominent producer – was for the most part written off as a player in the production arena altogether. One analyst estimates that Malaysian output will jump to 60,000 tonnes in 2003-04, from 40,000 tonnes this past season. Production had dwindled to 30,000 tonnes in recent years.

Another improbable contributor is Brazil, whose crops have been plagued by pests and have also driven this country from being a major producer. After seeing output sink to as low as 125,000 tonnes in 2001-02, it is expected to bounce back with a crop of 175,000 tonnes.

We believe that much of the strength in prices we are witnessing has as much or more to do with commodity funds getting tired of their short position as it does with developing bullish fundamentals. Over the past week, the funds' net-short position swung by 12,349 contracts to turn the group net-long. With the short covering out of the way, we will feel somewhat more confident that the price action will be more reflective of the fundamentals than they were over the past several weeks.

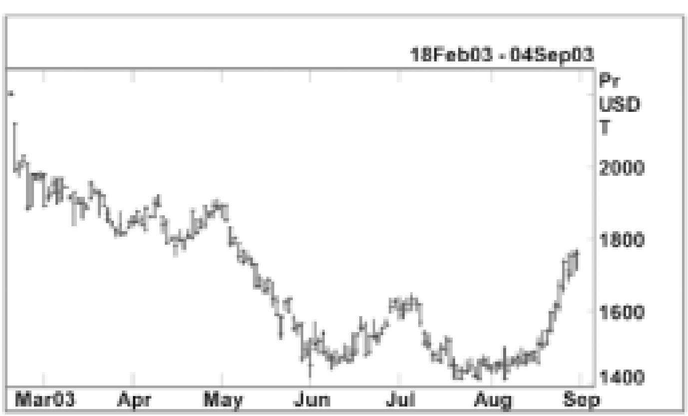
In the Ivory Coast, early pod counts have been healthy. If the weather improves and the labor shortage issue is sorted out, there will be another huge crop. Getting bullish at over $1,800 per tonne doesn't seem to be a brilliant idea.

At the moment, we remain neutral until the Ivorian picture becomes clearer, but the bias leans to the bear side.

[September 1, 2003]

STRATEGY: *Stay closely tuned.*

Chart 3 – December cocoa



Courtesy Reuters

SOYBEANS

US ending stocks still declining

Favorable early forecasts for the 2003-04 US soybean crop capped a bull run back in June that for some time tinkered with the $6-per-level. Prices fell sharply. The optimism regarding the crop, however, was premature, and after a close-to-$1-per-bushel selloff we've come roaring back and once again are trying to push through long-standing resistance levels.

The August USDA supply/demand situation report revised the estimate for the 2003-04 US crop downwards by 630,000 tonnes, to 77.89 million tonnes. But that is only part of the story. Those data were already a bit stale at the time of their release, and are more so now. The good-to-excellent portion of the crop has fallen from 70% at the end of July to 48% as of the most recent crop progress report.

Given the explosive growth in usage of protein feeds over the past several years and considering that there are only four countries in the world that grow enough soybeans to meet domestic needs with enough left over for export, this market is vulnerable.

South American producers Brazil and Argentina have provided relief in a big way. Once again, Brazilian output is expected to increase substantially from the previous season. Early estimates are calling for a 56-million-tonne crop (USDA) with local private forecasters upping that to 57 million tonnes. This compares with 2002-03 output of 52.5 million tonnes and a 2001-02 crop of 43.5 million tonnes. The Argentinean crop is estimated to reach 37 million tonnes, compared with 35.5 million tonnes in 2002-03 and 30 million tonnes in 2001-02. This is now the second season in which South American production will be larger than that of the US.

As vital as South American production is to world supply, the US role is still crucial for the period between the two continents' crops. Through the end of 2002-03, US ending stocks have become smaller and smaller in each year since the 1998-99 season. Based on the August USDA report, ending stocks are estimated at 6 million tonnes, or 7.9% of consumption. This compares with 2002-03 ending stocks of 5.12% of consumption and 7.1% at the end of 2001-02.

Judging by the crop progress reports over the past few weeks, it is almost certain that there will be a downwards revision in the 2003-04 US crop in the September USDA report, which means there will be little, if any, improvement in the carryover stock picture over 2002-03 record low levels.

There is a constant flow of press reports about bureaucratic holdups of Chinese imports. It is difficult for anyone to know how much of it is genuine concern for health and sanitation standards and how much is political posturing. One thing is certain, though: The Chinese have made negligible gains in the size of their soybean output over the years, but usage is growing and China will continue to be a major importer. Chinese production for 2003-04 is estimated at 16.6 million tonnes, compared with 16.5 million tonnes in 2002-03 and 15.4 million tonnes in 2001-02. Domestic consumption has grown at a much faster pace. This year's usage is estimated at 35.7 million tonnes, compared with 32.9 million tonnes in 2002-03 and 28.3 million tonnes in 2001-02.

The USDA makes the assumption that the US will lose business to South America and has forecast Brazilian exports at 22.27 million tonnes, up 2 million tonnes from last season. It has lowered US exports to 27.22 million tonnes from 28.3 million tonnes in 2002-03. With a jump in global consumption of 11.5 million tonnes, or 6%, it is not unreasonable to assume that the US will fare better than the USDA estimate. Indeed, the new marketing year is off to a good start for US exporters. As of Aug. 21, new-crop commitments stood at 7.159 million tonnes, a sharp increase over commitments of 4.108 million tonnes at the same time last year.

Development of the US crop and export flows are the key items to watch for. If the weather scare of the past few weeks turns out the way most weather scares do – a flash in the pan – prices will be susceptible to harvest pressure and are likely to drift back to the $5-per-bushel neighborhood. If it's for real and exports kick in, the market will easily sail through any resistance levels. Then we'll have a serious bull market on our hands.

We're not about to chase this market – just yet. But we are definitely very interested in the long side.

[September 2, 2003]

STRATEGY: *Stay closely tuned.*

HOTLINE UPDATE

***Flash Update* – Wednesday, July 30, 2003:**
Good afternoon for Wednesday, July 30, 12:35 pm. This is a Flash Update. We have liquidated our long December gold position at 357.90.

Friday, August 1, 2003:
Good afternoon for Friday, August 1, 4:15 pm. The following is a recap of this last week's trade recommendation history and our latest recommendations and stop levels: On July 30 we liquidated our long December gold position at 357.90; we are currently long December corn at 213.5, with our stop at 208. All stops are close only.

***Flash Update* – Monday, August 4, 2003:**
Good morning for Monday, August 4, 9:30 am. This is a Flash Update. We have sold short September mini S&P at 983, placing our initial stop at 1001, close only.

***Flash Update* – Thursday, August 7, 2003:**
Good morning for Thursday, August 7, 11:20 am. This is a Flash Update. We have purchased December gold at 354, placing our initial stop at 346, close only.

Friday, August 8, 2003
Good afternoon for Friday, August 8, 4:55 pm. The following is a recap of this last week's trade recommendation history and our latest recommendations and stop levels: On August 4 we sold short September mini S&P at 983; on August 7 we purchased December gold at 354; we are currently long December corn at 213.5, with our stop revised to 209; short September mini S&P at 983, with our initial stop at 1001; and long December gold at 354, with our initial stop at 346. All stops are close only.

***Flash Update* – Tuesday, August 12, 2003:**
Good morning for Tuesday, August 12, 9:00 am. This is a Flash Update. We have covered our short September mini S&P position at 981.25.

Friday, August 15, 2003:
Good afternoon for Friday, August 15, 4:45 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On August 12, we covered our short September mini S&P at 981.25; we are currently long December corn at 213.5, with our stop at 209; and long December gold at 354, with our stop at 346. All stops are close only.

***Flash Update* – Tuesday, August 19, 2003:**
Good afternoon for Tuesday, August 19, 4:05 pm. This is a Flash Update. We have purchased September euro currency at 1.1140, placing our initial stop at 1.1080, close only.

***Flash Update* – Thursday, August 21, 2003:**
Good afternoon for Thursday, August 21, 2:55 pm. This is a Flash Update. We have liquidated our long September euro currency position at 1.0907.

Friday, August 22, 2003:
Good afternoon for Friday, August 22, 4:45 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On August 19, we purchased September euro currency at 1.1140; on August 21 we liquidated our long September euro currency position at 1.0907; we are currently long December corn at 213.5, with our stop at 209; and long December gold at 354, with our stop revised to 357. All stops are close only.

Friday, August 29, 2003:
Good afternoon for Friday, August 29, 4:55 pm. The following is a recap of our latest recommendations and stop levels: We are currently long December corn at 213.5, with our stop at 209; and long December gold at 354, with our stop at 357. All stops are close only.

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