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US cotton crop surprises higher, but will it be enough?

The fundamentals of the cotton market – at least on the supply side – have been arguably the most bullish of any agricultural commodity. As plans for US 2008-09 acreage were being formulated, prices of all crops that can be alternated with cotton – primarily corn, wheat, and soybeans – had soared to record levels. While new-crop months in cotton had spiked to over 90¢ per pound as well, Charts 1 to 3 show definitively that it was more profitable to plant less cotton and more of the others. The charts also show that none of this should come as any great shock, because this trend has been developing for years.

And yet, while virtually every commodity on the board has taken a beating, cotton prices were the first to peak, way back in February. Has market action been commensurate with the fundamentals?

Although the USDA lowered the estimate for US planted area by 144,000 acres in the June 30 acreage report, to 9.246 million acres, traders were prepped by the weatherman for significant abandonment. The range of analysts' estimates was between 8.4 and 9.2 million acres, so with the actual figure coming in above the high end of the range, the number was a disappointment for bulls. The acreage report was certainly a meaningful event. Prices fell by 10¢ per pound in the sessions following the release of the report, setting new lows for the move (Chart 4).

On the flip side, the market has made no further downside progress throughout most of July and is currently testing the upper end of the recent trading range.

Crop development has been fairly steady. Headlines created the impression that Hurricane Dolly left damage in Texas. Some regions where bolls had begun to open were hit, but the affected region was less than 2% of the 4.7 million cotton acres in Texas.

Overall, the most recent weekly USDA crop progress report shows that 47% of the crop is in good-to-excellent condition, up 2 percentage points from the previous week. Last year at this time the top category stood at 54%. The USDA estimate for a drop in yield of 50 pounds per acre, to 830 pounds, has accounted for this.

The prospects for the US crop are clearly better than they were several months ago when cotton prices were much higher, but not materially so. The bullish case has not changed very much. Weather is always a wild card until crops have been harvested, but that is not the issue. We continue to believe that it is inconceivable that the market will get by without incident when the world's largest exporter of cotton is growing a crop that is 25% smaller than the previous season and 35% smaller than the year before that, all in an environment where demand continues to grow.

Even after the USDA revised Chinese domestic consumption for 2008-09 down by 1 million bales in its August supply/demand situation report, global usage is estimated at 125.91 million bales, up 1.66 million bales, or 1.3% from 2007-08, while production is expected to fall by close to 5 million bales, or 4.1%.

The resulting drawdown in global inventories will leave ending stocks at 53.24 million bales, or 42% of consumption, down from 2007-08 ending stocks of 49% of usage. The bulk of the inventories are purportedly Chinese, but as we've pointed out in the past, Chinese imports have grown by at least 10% per annum in over the past few years. The inventories are either myth or are not intended for use. Where it counts – in the US

Inside

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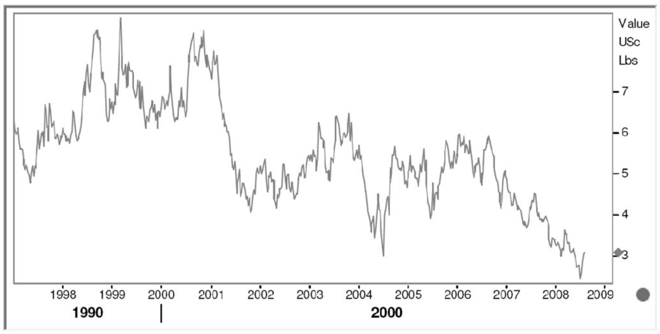
– 2008-09 ending stocks of 5.3 million bales will be half of last year's. If weather holds up, we could muddle through, but with any glitch in weather or stronger than expected exports, we'll see US stocks drawing down to historical lows.

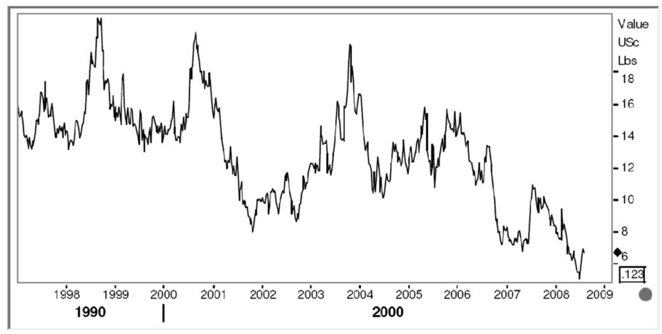
We reiterate that there isn't much new about this market – other than the additional pain we've experienced by staying the course with our long position. We recommend more of the same. *[July 30, 2008]*

Chart 1 – Ratio of cotton/soybeans



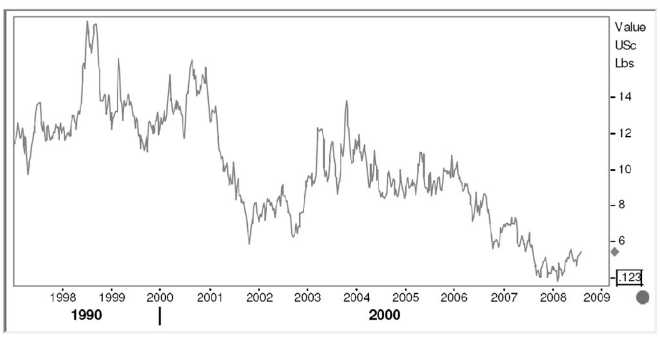
Courtesy Reuters

Chart 2 – Ratio of cotton/corn



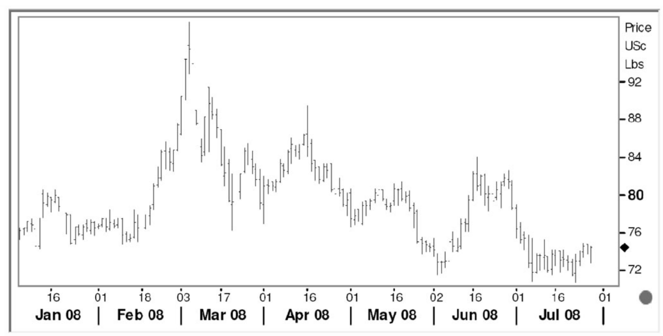
Courtesy Reuters

Chart 3 – Ratio of cotton/wheat



Courtesy Reuters

Chart 4 – December cotton



Courtesy Reuters

COPPER

Curtain call for a long and powerful bull market

When commodity prices were rallying indiscriminately over the past year, it was at times difficult to know if a particular market was strong on its own merit. Now that we seem to have established a cap on the broad bull market in commodities, similar challenges will be presented in the inverse.

Copper prices have been sliding to multi-month lows (Chart 5), but then again, prices of virtually all commodity groups have been in decline – precious and base metals, energy, softs, grains, and other agricultural markets.

According to the International Copper Study Group's (ICSG) most recent report, the global balance sheet showed a 108,000-tonne deficit for the first four months of 2008. The trend in both production and consumption is quite clear, and it appears that the deficit can be attributed to the supply side.

Production and labor problems at mines in Chile have kept output constrained. There have been a couple of months over the past year when it seemed that production was going to come roaring back, but overall output is stagnant. For the first half of 2007, average monthly mine production in Chile is down 1.45%. At the global level, mine production for the ICSG study period is down 3.3% from 2007. Apparently, this has been bullish enough to keep the market strong thus far.

On the other side, we're looking at the longest period in years in which copper consumption has not grown. In 2007 total global usage grew by 6.6%, to 18.2 million tonnes. Through April, however, global usage was down 0.06%.

It's no wonder. While the most recent data on US industrial production showed a recovery of 0.5% for June, there's been a rotation. Output has slackened in diverse regions, such as Japan and the UK, both of which registered negative industrial production numbers, in their most recent readings.

Chinese GDP has slowed marginally, and growth of commodity consumption is being affected as well. Imports of refined copper dropped 17.9% in the first half of 2007.

Global warehouse stocks remain fairly flat, although LME stocks have ticked up by 20,000 tonnes over the past month. As Chart 6 indicates, the trend is curling ever so sightly upwards.

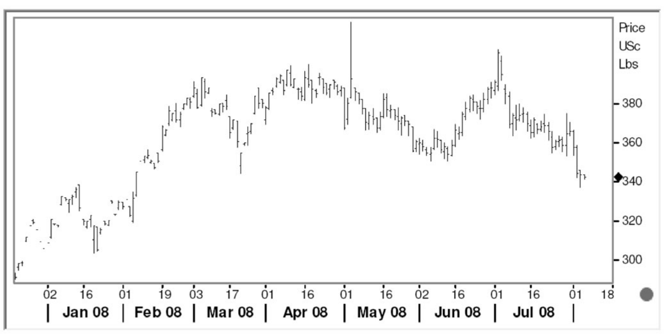
Backwardation at the LME has risen steadily since the beginning of 2008, but as Chart 7 indicates, has plunged during the market's recent selloff. The spreads at COMEX have been eroding all along (Chart 8), all of which is commensurate with the hard data that show that demand has fallen substantially.

In conclusion, bad commodity days in this environment mean that every commodity on the board gets clobbered. This doesn't necessarily mean that the supply/demand fundamentals of each market have been synchronized. But we're confident that copper fundamentals have turned decidedly bearish.

We've been reluctant to take an outright short position in copper, or indeed, in any commodity, even where we've identified bearish fundamentals. As Chart 5 indicates, there have been sudden, sharp spikes that have had little or no connection to long-term fundamentals, and the copper market seems to be particularly susceptible to this type of activity. On the other hand, there is strong evidence that weakness in demand is overwhelming the weakness in output growth. The alternative strategy that we recommended – bear spreads – has not yielded fantastic profits, but continues to be a conservative and effective vehicle to play the short side of copper. Maintain short September/long March spreads.

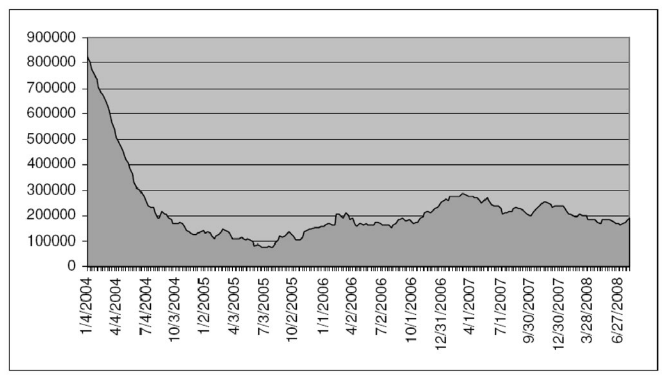
[August 6, 2008]

Chart 5 – September copper



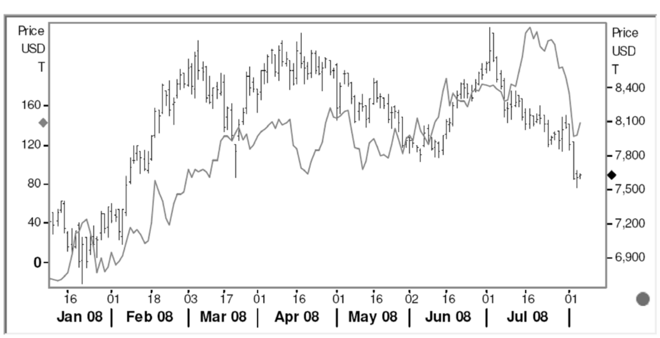
Courtesy Reuters

Chart 6 – Global copper warehouse stocks



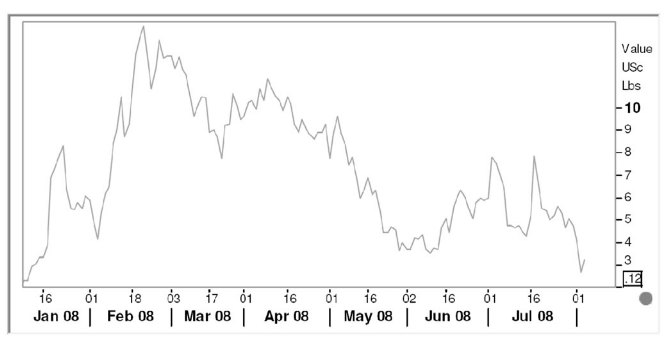
Courtesy Reuters

Chart 7 – LME copper (bar), LME cash/3-month (line)



Courtesy Reuters

Chart 8 – Comex September-March spread



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WHEAT

Yes, a big jump in supplies, but is it edible?

Way back in March, wheat prices were early among commodities to set a top (Chart 9). After a $5-per-bushel plunge, the market found a bottom at $7.50 per bushel. Weather concerns sparked a significant rally in June. A *déjà vu* drought in Australia was the featured problem. Most developments over the past two months have been bearish for prices, however, and the downtrend resumed soon enough. The market came back to the lows, but has now seemed to find some support.

The success of the Australian crop has been shown to be a swing factor for the global market. Fears that we might be looking at yet another drought was disturbing in a market that was desperately trying to rebuild global inventories. But the rains came, and although the crop still needs to grow, the situation down under certainly looks much better than it did one month ago.

As we head into the August 12 USDA crop report, commodity analysts have been churning out bearish estimates. On August 5, Informa Economics raised its estimate for US spring wheat by 410,000 tonnes over the July USDA forecast. On July 31 the International Grains Council revised its forecast for global production upwards by 4 million tonnes. On August 7, F.O. Licht increased its estimate for the world crop by 2.6 million tonnes. The headlines support the downdraft and seem to indicate that the bull market is dead. Furthermore, cash wheat prices continue to trade inexplicably about $1.5 per bushel below futures, and the matter is the subject of a CFTC investigation.

There are several developing issues that may help explain the existence of the premium in futures prices and the sharp pop off the lows.

Europe and the FSU are set to harvest robust, recovery crops. According to the July USDA supply/demand situation report, the EU will harvest 141.7 million tonnes in 2008-09, up sharply from 2007-08 output of 119.48 million tonnes. The FSU will produce 102.34 million tonnes, up from 92.69 million tonnes. But while the rains in Europe produced large crops, the moisture was excessive in some cases, resulting in lower protein values. For example, in 2007-08, the Ukraine produced 13.9 million tonnes of wheat. This year it is slated to harvest 21 million tonnes. One industry analyst estimates, however, that 80% of the crop will be feed quality, compared with only 45% last year. The agriculture ministry's estimate isn't as extreme, but either way it could conceivably turn the Ukraine into a net importer of food-quality wheat.

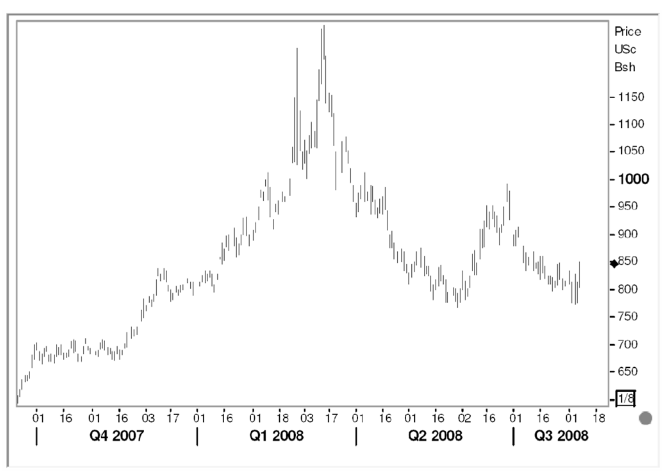
US futures contracts are pricing milling-grade bread wheat. The sudden oversupply of carbohydrate feed may be bearish for corn prices, but it also should mean that the USDA's slashing of its estimate for 2008-09 wheat exports by a rather drastic 21%, to 27.7 million tonnes, has been a premature move. The assumption was that overseas buyers will meet their needs closer to home, but their options may be limited, and they will turn to the US.

With 86% of the US winter wheat crop already harvested, there was little to worry about regarding the spring crop, particularly because it comprises just over 20% of the total crop. Crop conditions for all US crops had been improving over the past few weeks, so it came as a bit of a surprise when the most recent weekly crop progress report showed that the good-to-excellent portion of the spring wheat crop had fallen by 4 percentage points. The market did not react to that news initially. A story was being floated that a hedge fund that had exposure to long grains was forced to liquidate grain positions, and the market made a new low. After shaking that off, the market posted a near-limit up move.

Global ending stocks sank to a modern-day low of 18.6% of consumption at the end of the 2007-08 marketing year. Even after accounting for the extraordinary close-to-10% jump in global output, stocks will increase to only 20.5% of usage. In the 10 years prior to the start of the bull market, the average global stocks-to-consumption ratio was 30.2%. So unless demand is affected by economic slowdown, we have not accomplished all that much in terms of restocking global storehouses.

Bull markets create bear markets by resupplying the market, and as illustrated, the global farmer made a valiant effort, but we're not certain if he succeeded. We don't have a recommendation for new positions, but we maintain a bullish bias. Bulls who have toughed it out should definitely not allow the market to slip beyond the lows, and should use a $7.65-per-bushel stop, basis December Chicago Board of Trade wheat. Stay tuned. *[August 8, 2008]*

Chart 9 – December CBOT wheat



Courtesy Reuters

SUGAR

Beyond the surplus

Sugar has been the strongest commodity on the board over the past two months (Chart 10). Prices peaked earlier this year (Chart 11), and the sugar market participated in the broad commodity thrashing. Curiously, though, the market has climbed back. The timing is a bit odd, because to the extent that sugar is a nouveau energy market, its behavior should be dictated by the activity of the primary energy markets. Petroleum and natural gas prices have fallen dramatically, and the urgency of creating alternative energy solutions – which in the past has been expressed by investors flocking to buy sugar – might have eased.

Indeed, an examination of the open interest reveals that investors have tired of this market and are probably not responsible for the recent strength. Chart 12 shows a steep plunge in open interest. More importantly, the rally over the past two months specifically has not attracted much speculative interest. In fact, CFTC data show quite clearly that although commodity funds still hold a large net-long position of 112,000 contracts, that position has fallen from its peak of 240,000 contracts at the beginning of the year. What, then, is driving this market?

On July 28 F.O. Licht released an update of its outlook for sugar, which included a forecast for a 2007-08 global surplus of 9.6 million tonnes. The press chose to quote an item from the report that read: "It's no exaggeration to state that global inventories are out of control with the total at the end of September 2008 estimated to reach a staggering 84.2 million tonnes." What they neglected to mention is that the surplus estimate was 2.4 million tonnes below Licht's last estimate.

Licht points out that production for 2008-09 is expected to drop. Output in all major sugar producing areas has stopped growing. While the gap between the price and production costs of many internationally traded commodities has widened significantly over the past two years, and remains so even after the recent downturn in prices, profitability of sugar growing has stagnated. In Brazil it is estimated that world prices would have to reach 17¢ per pound to provide incentive for expanding sugar area and construction of crushing facilities. Energy costs and the rising real have sucked the profitability out of sugar farming and processing.

Moreover, skeptics argued that while 62.5% of the crush was being diverted to ethanol production in the early part of the crush season, the ratio would taper off. We are monitoring this ratio, and while it has come off slightly, to 61% in favor of ethanol, it is still substantially above last year's 55%.

The turnaround in the Indian situation is fascinating. The estimate for 2008-09 sugar production, which will be crushed in October, has fallen to about 21 million tonnes, down from 26.5 million tonnes in 2007-08. The planting season for the 2009-10 crop has begun, but rainfall is about 2% below normal. Early estimates are for a crop in the neighborhood of between 18 and 19 million tonnes. Domestic consumption is estimated to grow to 22 million tonnes, which means that exports are ancient history.

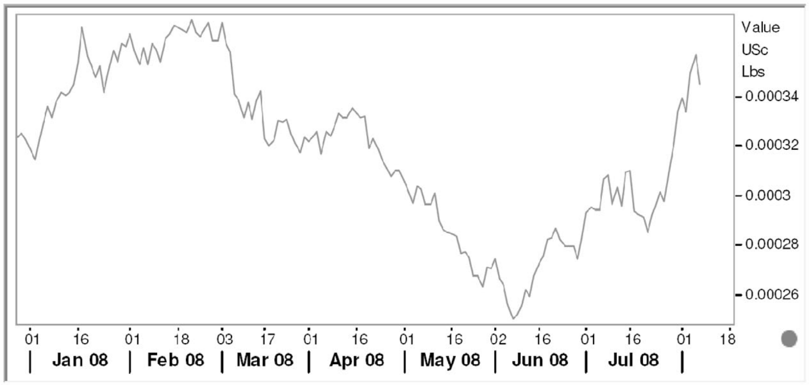
EU sugar reforms that reduced subsidies have had their desired effects. Production in 2007-08 was flat, but is forecast to fall 5% in 2008-09. Exports in 2007-08 were already down 35%.

We don't hear much about China in discussions on sugar, mainly because it has been self sufficient, more or less, importing about 1 million tonnes per year. For 2008-09, production is forecast to reach 14.5 million tonnes, about the same level as 2007-08. Consumption, however, is estimated to grow by 1 million tonnes, to 15.4 million tonnes, making China an interesting wild card.

Oh yes, let's not forget the burdensome carryover stocks that equal 50% of consumption. The largest and only significant concentration is in India, and recent history has shown definitively that the only implication is that India will run down its inventories if there is a domestic shortfall and then import to rebuild its stocks, which took sugar to 20¢ per pound in 2006.

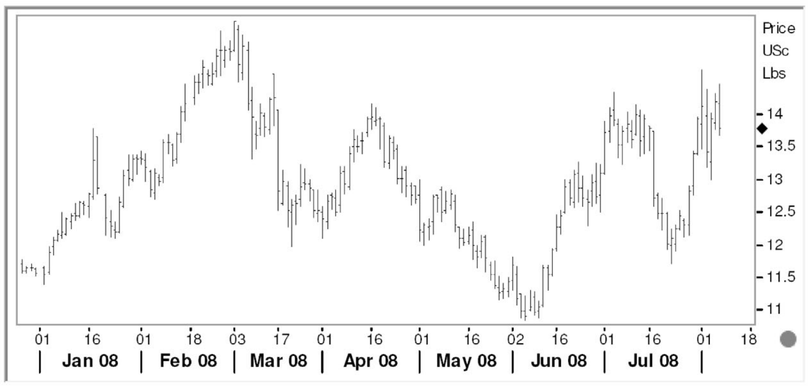
We anticipate that sugar prices will buck the trend of falling commodity prices. Remain long. *[August 8, 2008]*

Chart 10 –Sugar/CRB ratio



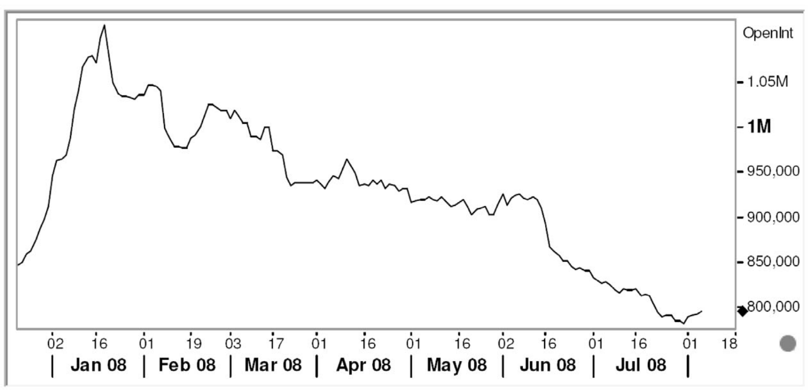
Courtesy Reuters

Chart 11 –October sugar



Courtesy Reuters

Chart 12 –Sugar open interest



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