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Corn: will anyone pay these prices?

The August USDA crop report contained some of the largest and most dramatic revisions on record. All eyes were on the 2012-13 US corn crop, which has taken a drastic beating from this summer's early and unusual heat.

The brutal weather began its damage in early June. The estimate for the bushel-per-acre (bpa) yield was already cut in the July crop report to 146 bpa, down from the June 166-bpa estimate, which would have produced a record-by-far crop of 14.79 billion bushels. The average of analysts' guesstimates for the August report called for a further steep drop, to 127.33 bpa, with the actual figure coming in at 123.4 bpa. The difference between the estimate and guesstimate was close to 350 million bushels, large enough to be a game changer.

The overall results of the report, however, were much closer to what analysts had anticipated. The USDA made significant provisions for demand rationing. The estimate for 2012-13 feed usage was slashed from the July estimate by a whopping 725 million bushels, to 4.075 billion bushels. The estimate for ethanol usage was cut by 400 million bushels, to 4.5 billion bushels. The forecast for exports was lowered by 300,000 bushels, to 1.3 billion bushels.

The average guesstimate for US 2012-13 ending stocks was 660 million bushels, and the number came in at 650 million bushels, or 5.8% of consumption, all but right on the money. That compares with last month's estimate of 1.183 billion bushels, or 9.3% of consumption.

The yield was the headline item and attracted some buying when the report hit the wire, pushing December corn to a new record high of $8.49 per bushel, but the euphoria did not last long. The market closed out the day down from the previous session (Chart 1). Buy the rumor...

Where does the market go from here? Enough respectable analysts believe that the crop is subject to more bad news and that yields will be revised lower yet again in the September crop report.

On the global front, Brazilian, Argentinean, and Chinese output was revised upwards by a combined 11 million tonnes. Those increases were mostly offset by crop losses in the other significant Northern hemisphere producers who were afflicted by drought as well.

Even if the USDA's estimate for US output is already in the right ballpark – and it might be – demand will eventually become the pivotal issue. So far, there seems to have been some sticker shock. Old-crop US sales ground to a halt when prices began to rise. Consider this: Average weekly old-crop export commitments since the first week in June have been 127,000 tonnes. That's very weak, even when compared with the same period last year, which also had very poor new old-crop sales. New old-crop sales for 2010-11 for the comparable period were 432,000 tonnes. In the previous two seasons, new old-crop sales from early June through mid-August averaged 701,000 tonnes in 2009-10 and 695,000 tonnes in 2008-09.

The USDA responded by lowering its target from the July estimate of 40.67 million tonnes, to 39.37 million tonnes – but that won't do the trick. We will not reach the downwardly-revised estimate. Shipments stand at 36 million tonnes, and with only three weeks left to the marketing year and shipments averaging about 500,000 tonnes per week, the final number will be about 37.5 million tonnes.

The USDA cut its estimate for 2012-13 global

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demand by 4.3% from the July estimate. That compares with a 6.2% drop in output, which will result in a draw-down in global inventories. Prices should move higher if there is evidence that the sticker shock that we've seen begins to wear thin, which we believe is going to happen, sooner or later.

Buy December corn on setbacks and place stops based on your risk tolerance level. There is very little in the way of meaningful assistance from the chart.

[August 14, 2012]

Chart 1 – December corn

Courtesy Reuters

SOYBEANS

Can South American output fill the gap?

The US soybean market entered the punishing drought of 2012 with a bullish backdrop. First, analysts expected a significant amount of soybean area to be lost to corn planting. In addition, overseas demand was very strong. Then came the heat and dramatic crop losses, dwarfing the bullish impact of smaller acreage and demand.

The August crop report showed that the average yield for the 2012-13 US crop dropped to 36.1 bushels per acre (bpa), down from the July estimate of 40.1 bpa, which was already slashed from the 43.9-bpa June estimate. The August estimate was below analysts' estimates of 37.753 bpa. The market rallied on the report, but failed to take out the late-July highs (Chart 2).

As it turned out, acreage was not a bullish factor. New-crop soybean prices were depressed *vis-à-vis* corn when early planting-intention estimates for the 2012-13 crop surfaced (Chart 3). In March, the USDA estimated US soy area at 73.9 million acres, which would have been down from 77.4 million acres and 75 million acres in 2010-11 and 2011-12, respectively. Then – between January and May, long before there was even a clue about the drought and its magnitude – soybean prices rallied in time for farmers to beef up soy intentions. The June 29 planting intentions estimate jumped by over 2 million acres, or 3%, to 76.1 million acres, without compromising any corn area. With acreage near all-time highs, soy area ceased to be a bullish factor at all. Once the drought began, though, the extra acres made no difference at all as bean prices shot right past the 2008 highs.

Rising prices have softened overseas sales to a degree, but thus far we have not seen any serious demand rationing, at least not to the extent that we've seen in the corn market (see *Focus on Futures*, August 15). The export sales target for the outgoing 2011-12 marketing year will be missed by a relatively small margin. Shipments stand at 35.2 million tonnes against the USDA estimate of 36.74 million tonnes with three reporting weeks remaining. Weekly shipments have been averaging 450,000 tonnes, which would leave sales shy of the target by about 200,000 tonnes.

Looking ahead, the USDA cut the forecast for new crop sales by 7 million tonnes, or 19%, to 30.21 million tonnes. Not necessarily because the demand will not be there, but because if output estimates are correct, every last soybean in the US would have to be sold to maintain export trends of recent years.

In fact, at 16.24 million tonnes, new-crop commitments are ahead of same-time-last-year sales by a wide margin of close to 6 million tonnes. Just this past week, US exporters sold 925,000 tonnes, more than half of which was purchased by China. So with any decent pace of continued exports, the US will come as close to running out of soybeans as it ever has. Ending stocks as a percentage of consumption will fall to 4.2%.

It all sounds like a very compelling bullish case. The US is no longer the supplier of last resort, however, and if Brazil and Argentina can avoid crop problems, the market will not be as tight as it feels from dwelling only on the US crop and the drought.

The past two seasons have seen Brazil and Argentina alternate crop failures. Even so, together the two countries harvest more beans than the US. If early estimates, which at this point are obviously based solely on planting intentions, are anywhere near accurate, the global soybean market should be amply supplied.

In the August crop report, the USDA raised its estimate for 2012-13 Brazilian output by 3 million tonnes from the July estimate, to 81 million tonnes, compared with 65.5 million tonnes in 2011-12. Argentinean output is forecast at 55 million tonnes, up from 41 million tonnes this past season. Combined production of 136 million tonnes is up from 106.5 million tonnes and 124.5 million tonnes in 20011-12 and 2010-11, respectively. The downwardly revised US crop, by contrast, is now estimated at only 73.27 million tonnes, down sharply from 83.17 million tonnes in 2011-12. If all goes well, South American output will compensate for the US crop failure.

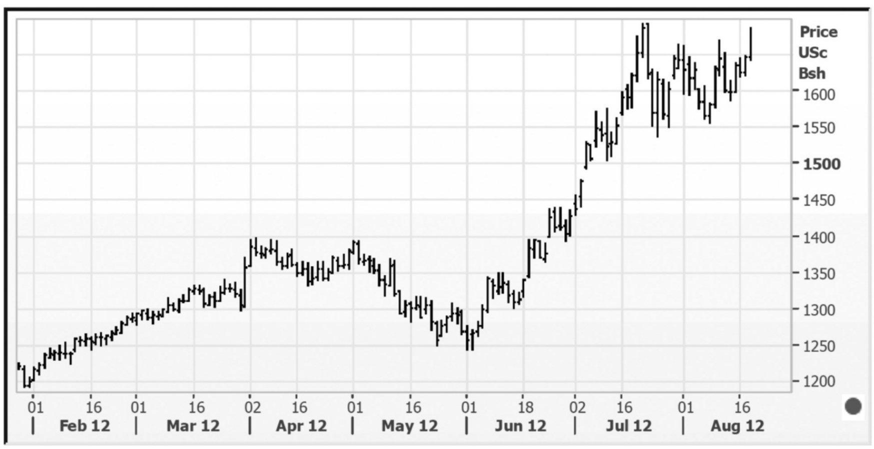
The estimate for 2012-13 global ending stocks as a percentage of consumption fell to 20.77% of usage, down from the July estimate of 21.15%, and actually a bit higher than last year's 20.46%. This is the low end of the range of recent years, but just to provide perspective, ending stocks during the bull market of the mid-1990s saw global inventories fall to as low as 12% of usage.

The bullish case is obvious. The bearish case is that the Chinese will eventually become price-conscious, and if South American crops do not disappoint, the global picture is not quite that tight.

Prices are likely to move higher in the near term, while there is still uncertainty about the size of the US crop. Remain long November beans. Raise stops from $13.80-per-bushel, basis November, to $15.40, close only.

[August 20, 2012]

Chart 2 – November soybeans



Courtesy Reuters

Chart 3 – November soybeans/December corn

Courtesy Reuters

WHEAT

The wheat bull...made in the FSU

The corn and soybean markets have grabbed all the agriculture-related headlines lately. But what about wheat? Well, at least as far as the US is concerned, there hasn't been too much to say. Wheat crops escaped the drought. For that matter, the August USDA crop report revised the size of the US crop upwards, by 1.2 million tonnes, to 61.73 million tonnes. Farmers increased wheat acreage to produce the largest US crop since the 2008-09 season. The winter wheat harvest is complete, and 89% of spring wheat has been harvested.

Nevertheless, wheat prices have rallied by close to 40% since early June – about the same as soybeans. Foreign producers, particularly in the FSU, suffered from drought as well, and produced some dismal results.

The crop report cut a further two million tonnes off Kazakhstan output, to 11 million tonnes, but raised the estimate for Ukrainian production by the same amount, to 15 million tonnes. That compares with crops of more than 22 million tonnes for each of these countries in 2011-12. This was not news, though, because the first estimate for global crops back in May already acknowledged these potential crop losses, and the estimates have not changed much since.

Many analysts, including the USDA, had an artificially high number for Russia, but the estimates are now tumbling. The August crop report slashed six million tonnes off the Russian estimate, to 43 million tonnes, down from output of more than 56 million tonnes last year. More recent estimates by some private forecasters put the crop size as low as 39 million tonnes. Using the lower estimate, total FSU production will be 80 million tonnes, down 30% from 2011-12.

EU crops were affected as well, but by a much smaller margin, at least in volume terms. Total output is expected to fall by about four million tonnes, or 3%, from last season. The problem with EU crops is quality, which means that a significant percentage of the crop will only be suitable as animal feed, leaving a tight market for milling-grade, food-quality wheat.

Indian crops continue to improve. The estimate was revised up by three million tonnes, to 94 million tonnes, up from 87 million tonnes last year. The excellent Indian crop, however, does little to mitigate the overall picture.

Global output is estimated to drop to 662 million tonnes, down 4.7% from 2011-12. Consumption is forecast to slip to 683 million tonnes, down only 1.7% from the previous marketing year. The resulting production/consumption deficit will draw global inventories down to 25.3% of usage, compared with 28.4% and 30% in 2011-12 and 2010-11, respectively. In the mid-2000s, stocks fell to just shy of 20% of usage, so we're not in such bad shape yet.

Argentinean farmers planted smaller acreage than last year, but that is well known and is in the market. The one area of vulnerability in the Southern Hemisphere is Australia, the world's second largest exporter behind the US. Dry weather is threatening crops in Western Australia, the largest wheat producing region in the country. Estimates vary, but several million tonnes are at stake if the area does not receive sufficient precipitation over the next couple of months.

Demand has been sluggish, at least in terms of US exports. The USDA estimates that US exports will grow by 14% in 2012-13, but export commitments are behind last year's pace by 12%. However, the market for milling grade wheat from EU and FSU origins should tighten eventually, as illustrated above, at which point demand for US wheat should pick up steam, and estimates will head toward the USDA estimate.

Raise stops on long December wheat positions, from $6.40 per bushel recommended on June 7, to $8.50, close only. *[August 28, 2012]*

Chart 4 – December wheat

Courtesy Reuters

SUGAR

Have we met the sugar bear?

Unfavorable weather conditions in June and part of July in the world's two largest sugar producers – Brazil and India – threatened to compromise 2012-13 production. In Brazil, excessive rains hampered the harvest and lowered sucrose content. In India, the monsoon season got off to a slow start, leaving cane crops with insufficient moisture. Prices responded accordingly, with a strong rally up to 24¢ per pound.

Improved weather in both countries, however, stabilized the situation, ending fears of a global deficit. In Brazil, drier weather prevailed, allowing the harvest to advance. The Indian monsoon picked up some steam, and a disaster was avoided. The market has since erased the entire rally.

The rally was an accurate reflection of bullish supply-side fundamentals. Had the weather not cooperated, we would be looking at crop losses of several million tonnes in each of the two countries. The resulting global production/consumption deficit would have drawn stocks down enough to tighten supplies available for world trade. Conversely, the selloff back below the 20¢-per-bushel level has, we believe, been exaggerated to a degree.

To be sure, there were enough bearish developments on both the supply and demand sides to warrant the downdraft. The seasonal-demand period in the Middle East and Asia had ended. As recently as July, Chinese customs data showed large increases in sugar imports, which seemed to indicate strong demand down the road. Now, analysts are saying that 2012-13 imports will fall to 2 million tonnes, down from 3.5 million tonnes in 2011-12.

Finally, the sugar/ethanol ratio in Brazil has been favoring sugar. Even with falling sugar prices, sugar provides a higher profit margin. Recent estimates say that 48.7% of the cane crop was used for sugar, up from 47.1% in the 2011-12 season.

With dry weather through the balance of the harvest period, the Brazilian 2012-13 cane harvest could equal or exceed last season's production. If all goes well, export availability of 22 million tonnes will equal last year's. To put this in perspective, though, 2011-12 was an off year for production, with sugar production down about 2 million tonnes from the previous season. So while the worst-case scenario of export availability of below 20 million tonnes has been averted, it is still not a bountiful situation. In addition, analysts point out that although the cane harvest will probably be over 500 million tonnes, the sucrose content level is still suspect.

Falling ethanol production may be bearish for sugar prices in the short run, but the dynamics of the ethanol market in Brazil will eventually swing the pendulum in the other direction. The minimum government-mandated 20% ethanol blend for vehicles will not change. Demand for Brazilian ethanol for export is strong and growing. Total

Brazilian exports in the 2011-12 marketing year were 1.9 billion litres, and are expected to increase by at least 15%, to between 2.2 and 2.5 billion litres.

The soon-to-be-harvested US 2012-13 corn crop was devastated by drought and will be at least 12% smaller than the previous season's crop. The USDA slashed its estimate for ethanol consumption to the corn equivalent of 4.5 billion bushels, or 10% below the previous season. However, a good deal of usage is entrenched in the system.

One private analyst estimates that US exports will fall dramatically, but that only represents less than 10% of US usage. Domestic consumption, on the other hand, will fall by only 2%. The total drop in demand would be about 5%, much smaller than the USDA estimate. A political debate has commenced regarding the wisdom of maintaining the current mandated ethanol blend requirements, but we do not believe the mandate is likely to change.

This brings us back to Brazil where US imports of Brazilian ethanol are expected to jump significantly to compensate for the shortfall created by the smaller corn crop.

In the near term, we'll muddle through the early part of the marketing year, when corn supplies are ample and the US will not need to rely on Brazil. However, if Brazilian cane processors continue to favor sugar over ethanol production at the current rate, tightness in ethanol should emerge. Ultimately, the sugar/ethanol ratio will shift back to the levels we saw several years ago, tightening sugar supplies available for export.

Private industry analysts in India lowered their estimate for Indian output by 1 million tonnes, to 25 million tonnes. Some areas did indeed receive much better moisture as the monsoon improved. Other key areas did not. We're skeptical about this estimate, because a good part of the growing season was dry. One Brazilian analyst puts the Indian crop at 23.8 million tonnes, much closer to Indian domestic consumption, which of course means that India's ability to export is crimped. We expect to see final estimates for India to be a fair bit lower than 25 million tonnes.

Some analysts have raised their forecasts for the global surplus to reflect the recent crop recoveries in Brazil and India. The range of estimates is between 3 and 9 million tonnes, a rather significant divergence.

We were stopped out of our long position in October sugar at 22¢ per pound. Re-enter the long side. Buy March sugar, currently just above 20¢ per pound and place initial stops at 18.50¢ per pound, close only. *[August 29, 2012]*

Chart 5 – March sugar

Courtesy Reuters

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