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A disappointing US corn crop, but China applies the brakes

Bullish revisions for the 2010-11 corn harvest continued to flow in the USDA November crop report. The yield estimate was lowered yet again, down 1.5 bushels per acre from the October estimate and slightly below analysts' expectations, to 154.3 bushels per acre. The not-spectacular-at-all crop is now forecast at 12.54 billion bushels, 570 million bushels below last season. Even after downward revisions to domestic feed and exports, total demand is 350 million bushels higher than 2009-10. As a result, ending stocks will be drawn down to 827 million bushels, or 6.15% of consumption, down from an average of 13.4% in the two previous years. The last time US ending stocks were close to this level was in 1995-96, which ultimately resolved in a massive bull run from $2 to over $5 per bushel.

The market initially greeted the news with a rally to new highs for the move, but closed poorly that session and embarked on what has, thus far, turned into a $1-per-bushel slide (Chart 1). A classic buy-the-rumor-sell-the-news top?

To be sure, there have been some potentially bearish developments. Over the past few weeks, there's been a broad pullback in commodity prices. The correction was triggered in part by a 3.5% rally in the US dollar. While we're not offering any opinion regarding the direction of currencies in this forum, the dollar rally does not seem to have abated.

Other challenges to the bull case are directly related to the corn market. Asian buyers have shown a seemingly insatiable appetite for US soybeans and cotton, and the large numbers have shown no sign of letting up. For a while, corn exports looked equally extraordinary when the Chinese began importing corn for the first time in four years this past spring, but that fizzled out. Then, there was a three-week stretch this past summer when forward foreign purchases for the current 2010-11 marketing year popped and averaged close to 1.9 million tonnes per week. That was short-lived, though. Since early September, US export commitments have averaged a ho-hum 600,000 tonnes per week.

US export commitments for 2010-11 to date stand at 21.3 million tonnes, 2.6 million tonnes ahead of last year at this time. As noted earlier, however, the USDA revised its forecast for the marketing year down by 1.3 million tonnes in the November crop report, because of the limp pace of overseas sales. The commitment tally will fall behind last year's pace soon enough.

While the downgraded crop caught the headlines, other items in the November crop left little reason for optimism that large Chinese purchases will return. Private analysts have insisted that Chinese corn production numbers were overstated in 2009-10 and that estimates for 2010-11 were too high. Some have even suggested that the USDA's 155-million-tonne estimate for 2009-10 was really closer to 140 million tonnes. So the USDA surprised observers by raising estimates for both crop years – 2009-10 output was increased to 158 million tonnes, and the estimate for 2010-11 production was revised up by 2 million tonnes, to 168 million tonnes.

We nevertheless remain extremely bullish. Well regarded grain analyst Bill Gary (*Price Perceptions*, November 20) is not at all ambiguous in his suspicion about the size of Chinese output for 2009-10 and 2010-11. In fact, on November 22, the China Banking Regulatory Commission, a government agency, urged banks to be accommodative to the agriculture sector to alleviate shortages in some commodi-

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ties, with corn being cited specifically. Hard to believe if the Chinese just harvested a bumper crop and if upward revisions to old crop estimates were accurate.

Even with the cheerful Chinese crop estimates, global ending stocks stand at 15.4% of usage, down from the October estimate of 15.8% and significantly below last year's 18.2%. This is a drawback to 2006-07 levels when global ending stocks dipped down to 15% of consumption, which set the stage for the fantastic bull market of 2008. Whether or not the Chinese start importing sizeable quantities again, the market is tight.

The US farmer tried, but was unsuccessful at, addressing the long-term issue of growing enough corn to comfortably supply both the traditional feed market and the growing ethanol market, both of which continue to expand. The market remains vulnerable.

Open interest is very high, but the correction has made a dent in the composition. Funds have been reducing their net-longs (Chart 2). If this is the classic bull market we believe it is, the overbought conditions will be worked off with a relatively painless consolidation. Remain long.

[November 25, 2010]

Chart 1 – March corn

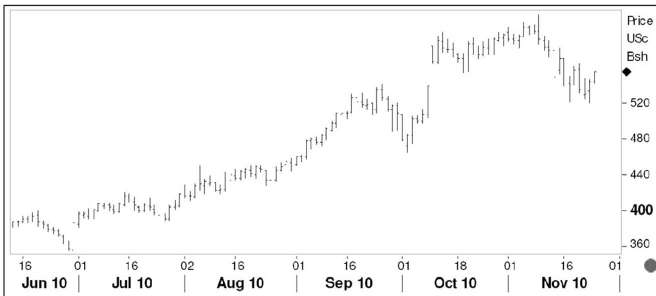

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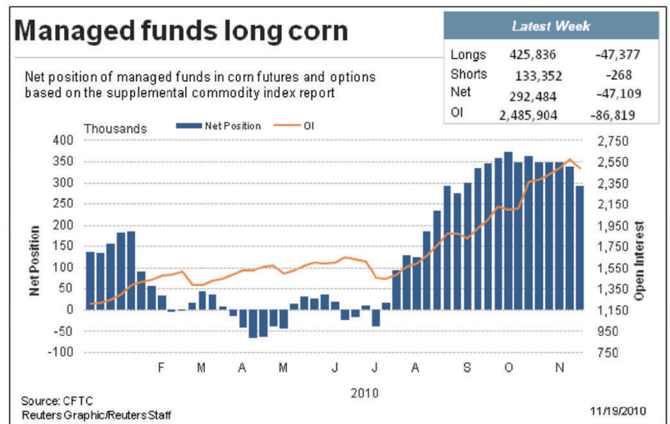
Chart 2 – Commodity funds' net position



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SOYBEANS

Asian buying surprisingly strong, but can it last?

January soybeans sprinted to new highs in response to a slate of mostly bullish data contained in the November 9 crop report (Chart 3). Traders were expecting the yield estimate for the harvested US 2010-11 crop to increase, from 44.4 bushels per acre (bpa) to 44.671 bpa. The estimate came in below expectations, though, at 43.9 bpa. The crop will still reach record levels of 91.85 million tonnes (3.375 billion bushels), but will be lower than the 92.76-million-tonne (3.433 billion bushel) October estimate.

In the days following the release of the crop report, news that China was taking measures to tighten monetary policy hit the markets, sparking a selloff in global equities and commodities. Commodities whose bull markets are closely tied to Chinese imports were particularly vulnerable, and certainly soybeans and soybean products rank high on that list. China grows only 21% of its soybean needs, making it almost completely reliant on imports.

Soybean prices have rallied by about 35% since the marketing year began on September 1. Aside from the general commodity mania that has driven prices higher across the board, there were very legitimate grounds for the bull run in bean prices. In the first two months of the 2010-11 season, export commitments for the newly harvested crop averaged 1.3 million tonnes per week, well above normal levels. Total commitments stand at 32.76 million tonnes, compared with 27.63 million tonnes at this time last year. Chinese buying is the difference. Chinese commitments comprise 21 million tonnes of the total this year, compared with 17 million tonnes last year.

The selloff following the November 9 crop report was exacerbated by fears that a shift in Chinese monetary policy could slow down soybean purchases. It may have seemed a bit premature when the USDA raised the record-high US export estimate by yet another 1.36 million tonnes. The Chinese monetary constraints, however, did not seem to have any immediate impact on US soybean exports. There's been a couple of soft weeks, but new sales in November managed a still-well-above-normal weekly average of 1.084 million tonnes.

The slightly smaller crop and the increase in the export estimate have pulled the estimate for US ending stocks down to 5.03 million tonnes (185 million bushels), or 5.5% of usage. In July, the ending stock estimate stood at 11.4%. The record crop was expected to provide a bountiful

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response to growing Asian demand, but it has not.

Brazilian and Argentinean production estimates keep inching up, but still remain below last year's level – 119.5 million tonnes, compared with 2009-10 output of 123.5 million tonnes.

To put things in perspective, we're not exactly running out of beans. The November revisions resulted in a lower global-ending-stock estimate of 24.1% of consumption, down from the 24.3% October estimate. That's lower than 25.3% in 2009-10, but well above 19.9% in 2008-09, which drove prices through the roof.

There are some variables, however, that can affect the market. The success of the South American crop is crucial. There is definitely historical precedent for very high early-season estimates that are trimmed down significantly by the time the harvest approaches. Thus far, the estimates have done nothing but inch up. With US inventories expected to be at critically low levels for a fourth consecutive season, South American crops will have to be robust and ample should Asian demand maintain the current or even slightly-lower-than-current pace throughout most of the marketing year.

In conclusion, the magnitude of Asian buying is a very bullish factor and has altered the whole complexion of this market. On the other hand, even if the US is "sold out," that will probably not happen until South American exporters can step in. The vulnerability lies in whether we get a bridge or a gap between the depletion of the US crop and the availability of the South American harvest early next spring.

Commodity funds have been liquidating long positions while the market was falling, which has alleviated the severely overbought conditions (Chart 4).

In the November 4 issue of *Focus on Futures* we bemoaned missing a powerful rally in the soybean market and suggested buying 50¢-per-bushel dips. The inevitable correction was actually more of a plunge than a dip, which should have allowed sufficient opportunity to get on the long side. An alternative strategy would be to buy soybean meal – the principal by-product of beans – which has underperformed soybean prices by a wide margin in historical terms (Chart 5). *[December 7, 2010]*

Chart 3 – January soybeans

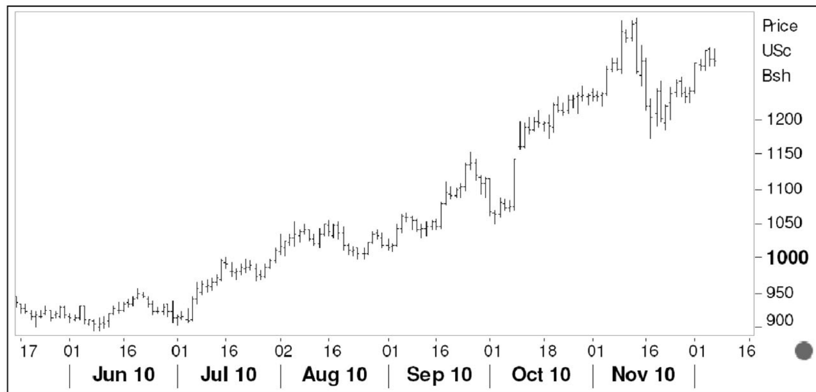

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Chart 4 – Commodity funds' net position

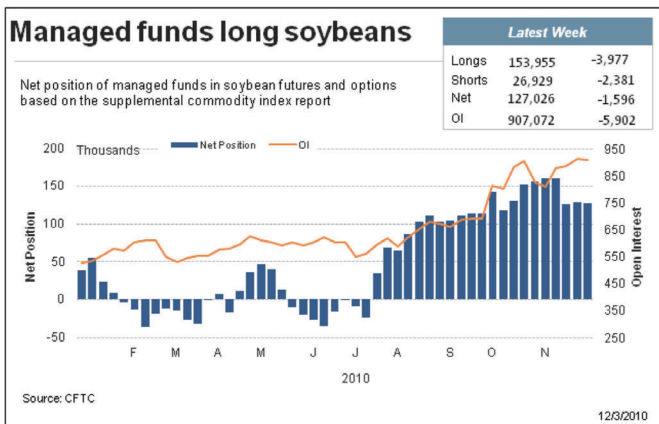

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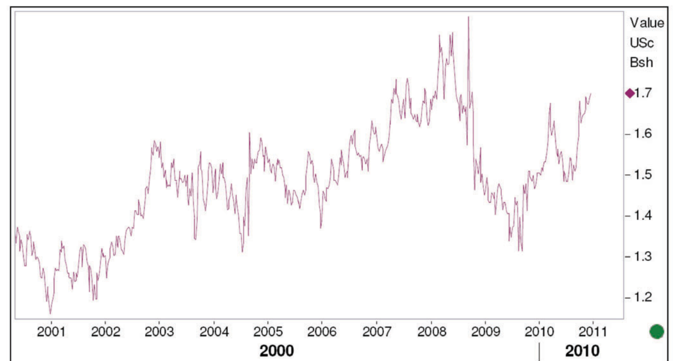
Chart 5 – Soybean/soymeal ratio



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COPPER

Strong demand and sluggish output send copper flying

Copper prices are a whisker shy of the all-time peak of $4.27 per pound set in May 2008 (Chart 6). The most recent data published by the International Copper Study Group (ICSG) show that from January through August of this year, the global market is in a steep production/consumption deficit of 363,000 tonnes. This compares with a deficit of only 47,000 tonnes for the same period in 2009.

The gap between growth in supply and demand continues to widen. Total refined production for the study period increased by 5.8% for the period. Primary production, which includes mine production, grew by 2.3%. High prices resulted in a 25% boom in secondary recovery, but that segment of the market represents only 17% of total supply.

Global usage, on the other hand, increased by 8.3% over the same period in 2009. While Chinese demand has slowed to a growth rate of only 4.5%, other key depressed regions in developed countries are posting results that are indicative of economic recovery. Volumes have still not returned to pre-recession levels, but are strong enough to overwhelm supply. Consumption in the study period for Japan, the EU, and the US increased by 30%, 12.5%, and 7.5%, respectively.

The timing for the recovery and subsequent uptick in copper demand in these regions was perfect, but that improvement should be put into proper perspective. China is by far the world's largest consumer of copper. Chinese consumption is greater than combined usage in Japan, the US, and the EU. Chinese imports carried the copper market during the recession, and any large changes in demand will still impact the market. The most recent import data were for October, and the numbers were soft. Analysts are concerned that the upcoming release of the November figures will continue to show slackening Chinese copper imports.

Indian GDP is growing at about 9% per annum. Its power infrastructure is reportedly running a 12% deficit. In scrambling to provide much-needed electricity to residential and commercial users, there are some 150 projects at various stages of production, which require huge amounts of raw materials. It is estimated that copper demand is growing at an annual rate of 7%, but some analysts say the figure could be much higher.

Chilean production for 2010 is estimated to grow by about 3.5%. But based on monthly data through the end of October, that figure is much lower. Earlier in the year there were some strong months, even in the aftermath of the devastating earthquake, which hardly affected the major mines in the north of the country. In the two most recent months for which statistics are available, September and October, output was 4.7% and 7% lower, respectively.

No help from other major copper producers either. Indonesian mines have been mining lower-grade ore, and as a result, official government forecasters estimate that production will actually fall over the next year.

Warehouse stocks continue to reflect dwindling supplies. Chart 7 shows that combined inventories at LME, Shanghai, and COMEX warehouses are still eroding.

Like other commodity markets, some of the moves are suspect in terms of whether the supply/demand fundamentals warrant rallies of the magnitude that we are seeing. Open interest is certainly high (Chart 8). The size of the commodity fund net-long position has surpassed the mid-decade highs (Chart 9), which should be a bit scary for bulls. On the other hand, funds have been liquidating long positions during this last spurt to a two-and-a-half year high, indicating, perhaps, that the exuberance may not be too irrational.

Remain long. *[December 10, 2010]*

Chart 6 – Nearest contract copper

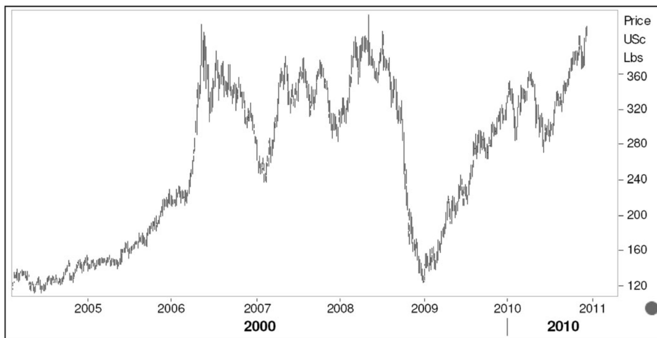

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Chart 7 – Global warehouse stocks

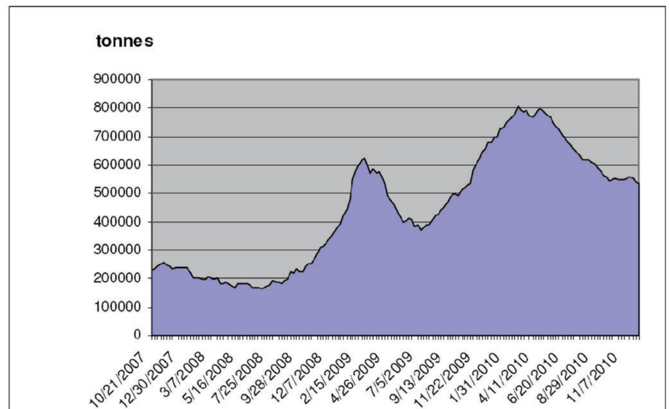

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Chart 8 – Comex copper open interest

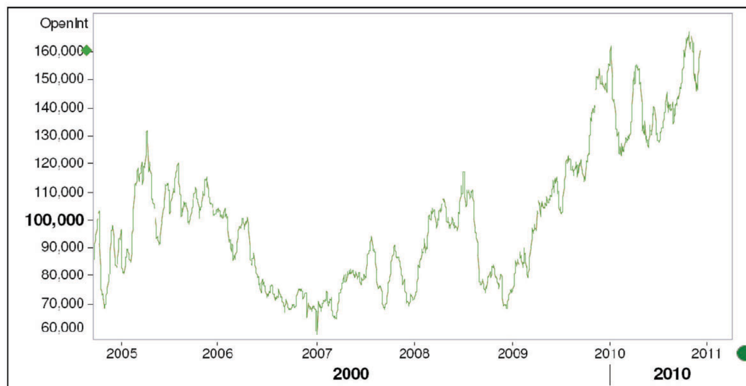

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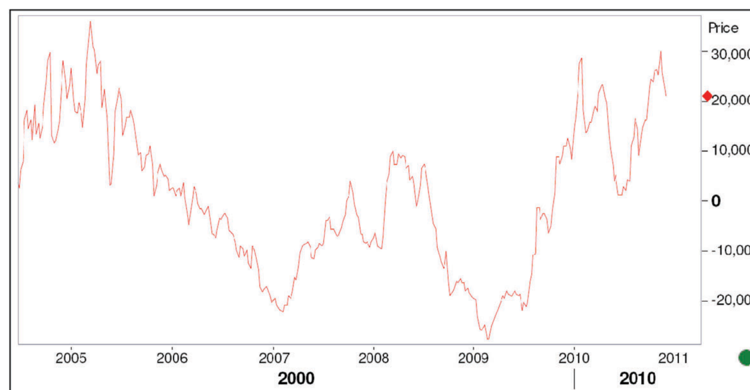
Chart 9 – Commodity fund net long position



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WHEAT

Indiscriminate bad weather

Chart 10 shows a two-day spike in wheat prices back in August that at first glance looks conspicuously out of place. And even to the trained eye it seems as though it could be a faulty tick that the service provider has neglected to fix. Of course that's not the case. It was the culmination of a bull run sparked by a killer drought in Europe that wreaked havoc with crops.

At first, it was believed that both Eastern and Western regions would be affected, but as it turned out, the damage to EU crops was minimal. Indeed, estimates for EU wheat output – at 136.26 million tonnes – have actually inched up in recent USDA crop reports and will be just 2 million tonnes, or 1.5%, below the previous year's output.

Eastern Europe was not as lucky. Total FSU wheat output in 2008-09 and 2009-10 was 115.45 million tonnes and 113.84 million tonnes, respectively. The estimates have been shrinking consistently since the European weather news broke. The December USDA crop report now estimates that 2010-11 FSU output will reach only 82.63 million tonnes, down an astounding 27.4% from the previous season.

Export availability from the three principal producers, Russia, Kazakhstan, and the Ukraine, is slated to fall by 20 million tonnes from 2009-10, to 16.7 million tonnes. And we draw attention to the odd-looking chart because despite this seemingly emergency situation that should have tightened the global wheat balance and that drove prices up by 70% in one month, the market collapsed. Prices fell by $1.65 per bushel before consolidating, a clear indication that global inventories were sufficiently fortified to withstand the Eastern European calamity.

The market drifted mostly in a 75¢-per-bushel range

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for the next two months until more bullish weather news in other wheat producing nations touched off the recent rally. Several potentially significant developments have emerged.

Heavy rains and even flooding in some areas have inundated Australian wheat-growing regions. The implications are a long delay to the harvest, reduced quality, and, of course, lower output. The Australian crop typically yields 90% bread-quality wheat. Analysts estimate that only 40% will be bread quality!

There is more rain in the forecast down under, so the estimates cannot be accurate at this time. The December 10 USDA crop report actually increased the forecast for the Australian crop by 1.5 million tonnes, to 25.5 million tonnes. The USDA makes mention of the excessive precipitation, but stuck to its optimistic forecast. In any case, even if the volumes are not affected, feed wheat is a whole other commodity.

Kansas is the largest US wheat producer, and about 35% of the state's wheat area is suffering from drought conditions, which is stressing the winter wheat crop planted this fall. Analysts say that the affected areas have not experienced such poor pre-dormancy maturity since 1991. The most recent crop progress report released by the USDA shows the good-to-excellent portion of the crop at 47%, compared with 63% at this time last year.

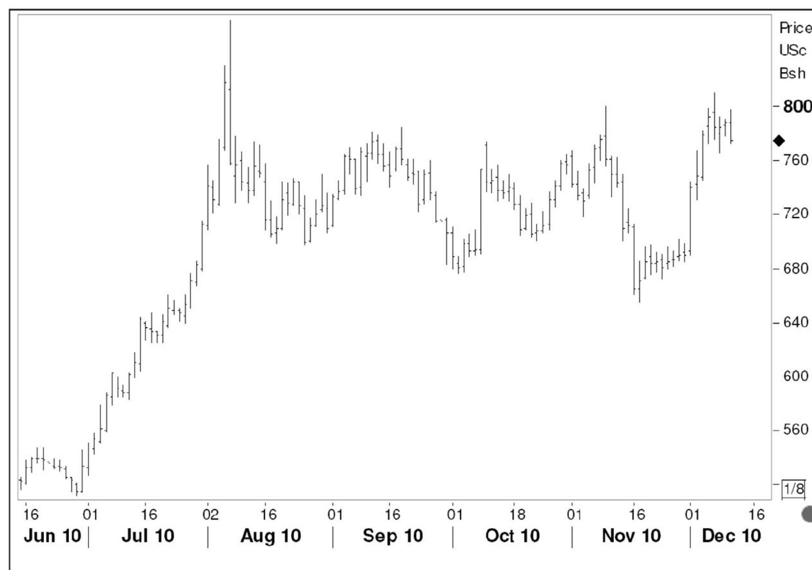
US exports are 8.7 million tonnes, or 60%, ahead of last year at this time. Weekly sales are still running at an above-average pace. The average of the past four weeks has been 720,000 tonnes, compared with last year at this time, when the four-week average was 350,000 tonnes.

Although the estimate for global ending stocks keeps slipping, we're hardly at a level that could be considered tight. The December estimate was revised to 172.51 million tonnes, or 25.9% of usage, down from the November estimate of 26.3% and 30% in 2009-10. With crop downgrades almost certain for Australia and the US, that figure will fall again.

The market survived the FSU crisis, but with these new potential crop failures it would seem that the bull market has resumed.

Buy March wheat at the market. *[December 13, 2010]*

Chart 10 – March wheat



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