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Corn demand drops sharply, but are supplies adequate for sharp drop in acreage?

The explosive bull market in crude oil is perceived to have been one of the primary driving forces behind the bull run in the feedstock commodities that are used to produce biofuels, such as corn, soybean oil, and sugar. Certainly, to a large degree, this has been true in the sense that policymakers were inspired to promote diversification of energy sources by facilitating subsidies that would reduce dependency on petroleum products. This brought rapid expansion to the industry, particularly in the case of ethanol. Now that crude oil prices have collapsed, we need to examine the degree of retrenchment we might see for demand of biofuel.

As expected – the USDA's monthly crop report, released on December 11, slashed its estimate for corn-for-ethanol consumption for the current marketing year by 300 million bushels, or 7.5%. As we explained in *Focus on Futures*, December 1, the bulk of that demand revision was on account of the bankruptcy of a large ethanol producer that was forced to cancel commitments of corn purchases. We are likely to see a consolidation in the industry that will leave more efficient producers. But the amount of ethanol consumed at the pump should fall only at the same pace as the demand for all goods and services.

While the price of ethanol may be lower than that of petroleum, the elasticity of its demand versus demand for petroleum is marginal. Even when crude oil was flying high, there was little price advantage, if any. Ethanol efficiency is only about 75% of petroleum, which means that there is typically no price advantage, unless the price of crude exceeds the price of ethanol by substantially more than the rate of efficiency. In fact, aside from the regions that sell pure ethanol, the consumption of ethanol in the US is not discretionary at all. Most of the ethanol consumed is sold as a gasoline blend of either 10% or 15% ethanol.

The ethanol industry is lobbying the Federal government to increase the minimum blend to 15%, up from the current minimum of 10%. Representative Collin Peterson (D-Minnesota), the chairman of the Congressional Agriculture Committee, supports the change. President-elect Obama dwelled on the subject of alleviating dependence on oil imports during his campaign and has continued to address the issue during energy-related cabinet appointments. This means the future President is likely to throw his support behind such an initiative.

A more important development in the corn market is the progression (actually regression) of early estimates for 2009-2010 acreage to be planted this coming spring. Informa Economic's first estimate on September 22 was for 90.5 million corn acres, up 3.5 million from 2008-09. The November 14 estimate fell to 85.9 million acres. The most recent estimate, released on December 12, was down to 82.3 million acres.

Smaller acreage is consistent with falling demand. In its December report the USDA revised global demand for corn down by close to 8 million tonnes. That's only 1%, but together with an increase in its production estimate, it was enough to drive global stocks as a percentage of consumption to 15.6%, up from the November estimate of 13.8%. However, this remains below the 2007-08 ratio of 16.5%, and still in the zone of the lean years that gave birth to the bull market in the first place.

For the first time in as long as anyone can remember, US export commitments were over 1 million tonnes (old and new crop combined), and above expectations at that, for the week ended December 4. The tally for the marketing year is still

Inside

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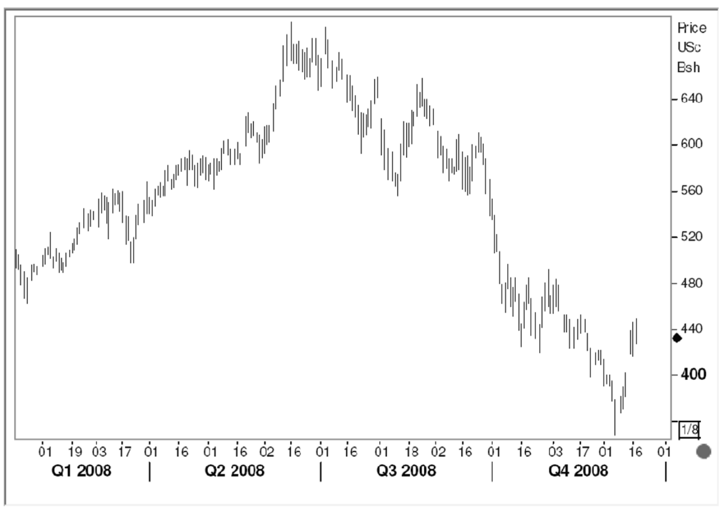
absolutely dismal and remains well below the level required to reach even the USDA's very pessimistic forecast of 45.7 million tonnes for the season, down from final sales for 2007-08 of 61.87 million tonnes.

But the gloomy outlook for exports is valid only if we continue selling corn at the 400,000-tonne-per-week pace we've become accustomed to. An uptick to normal levels with eight months remaining in the marketing year could cure all that in a hurry.

Corn prices have rallied by close to $1 per bushel over the past two weeks, and it will be interesting to see if the improvement in flow of sales was merely a flash in the pan. The follow-through this week was disappointing, with new sales dropping to 612,000 tonnes, but still somewhat respectable compared with the November average of 410,000 tonnes.

On December 1 we advised selling new crop months on rallies. We are going to recant. First of all, the 10% drop in the US dollar in the space of a few trading sessions alters the commodity landscape. More specifically related to corn though, the drop in acreage will probably not be limited to the US. The demand side looks bleak for corn and all commodities, but these markets have already fallen dramatically and may have accounted and over-accounted for the adjustment in global consumption. We prefer to observe from the sidelines for now. *[December 18, 2008]*

Chart 1 – December corn



Courtesy Reuters

SOYBEANS

Foreign sales cushion drop in domestic demand

The soybean chart looks pretty well like any other commodity chart: A massive bull run of unprecedented magnitude that began in 2006 and ended abruptly in mid-2008, followed by a collapse of historic proportion (Chart 2).

Bearish fundamentals of many commodity markets have justified the steep drop in prices with an equally sharp downturn in demand. With soybeans this has certainly been the case for US domestic usage. The USDA estimate for the 2008-09 crush is 46.68 million tonnes, down 4.8% from last season. Since the beginning of the marketing year for soy products on October 1, the crush is down 8% over the same period in 2007-08. If we look back to when the crush began to nosedive in August, we're actually down 16% over the comparable period last year, so the USDA estimate may still be a bit generous.

There are aspects of the soybean market, however, that are considerably more bullish than other markets. The most outstanding feature is the US export market. Unlike foreign sales of the other major US crops, corn and wheat, where sales are down dramatically from last year, soybean sales have little resemblance to the bear-market activity of most other commodities. Even after upward revisions of close to 1.5 million tonnes, or about 5%, over the past few months, the USDA estimate for 2008-09 sales stands at 28.58 million tonnes, still down sharply from 2007-08 final sales of 31.6 million tonnes.

Export commitment data indicate fairly clearly that the USDA is still behind. As of the most recent weekly report, exporters have contracted sales of 19.2 million tonnes, down only 3.7% from last season, compared with the USDA forecast that annual sales will be down 9.6%. And while it's still early in the season, which makes cancellations a possibility, shipments are out in front of last year's pace by 12% and represent 40% of anticipated final sales.

There are two specific developments that account for at least some of the strength in US exports. First, China has been stockpiling soybeans to keep domestic prices from plummeting, and is not necessarily responding to physical market demand. Then, Argentinean farmers have been holding on to a significant percentage of their 2007-08 crops in hope of higher prices. Once these factors fade, so might foreign demand.

On the supply side, the key growing areas in Brazil and Argentina are dry, and unless the weather changes significantly, the estimates for the 2008-09 crops to be harvested this coming spring are too high.

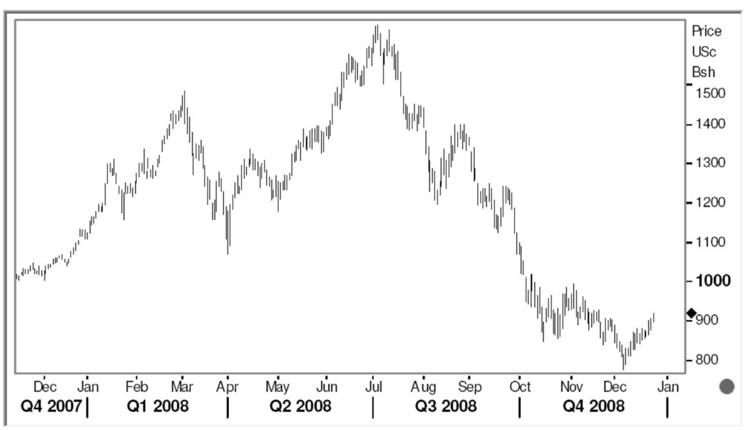
The relatively strong performance of soybeans over corn from September through November (Chart 3) possibly led Informa Economics to increase its forecast for 2009-10 US soy area, from 77.2 million acres in its November estimate, to 81.5 million acres in its December estimate. But as the chart shows, that relationship can change quickly and with it, the acreage ratio.

Strong foreign sales don't fully compensate for the loss of domestic consumption, but because of the export market, there has been very little improvement in either the US or global balance sheets – unlike the corn and wheat markets. US ending stocks are forecast at 5.58 million tonnes (205 million bushels), or 7% of consumption, compared with 6.7% at the end of 2007-08. Global stocks are estimated at 54.19 million tonnes, or 23.3% of consumption, compared with 23.1% in 2007-08.

Both US export flows and South American crop weather are volatile elements and can stop being bullish factors. If they do continue, however, the soybean market outlook is every bit as bullish as it was earlier this year, save for the fact that hedge funds don't have the ammunition to drive markets beyond prices fairly represented by fundamentals.

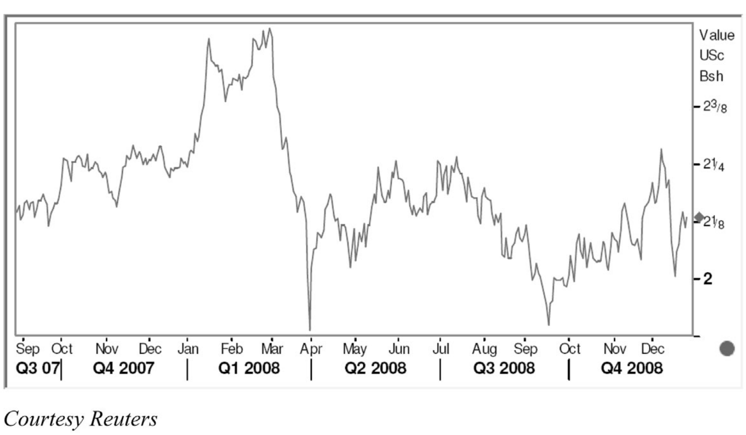
We were stopped out of our November 2 buy recommendation, and March soybeans are now back above our stop level by 70¢ per bushel. Commodity analysts remain resolutely bearish on soybeans (and everything else) and generally advise selling rallies. We disagree. The world economic situation will stabilize, sooner or later. The soybean industries in the major exporting countries have attempted to expand output, but it does not seem to be materializing. We're only muddling through because of the sudden drop in demand. If that comes back, we'll be drawing global supplies down to dangerous levels again in no time. Buy March soybeans. *[December 26, 2008]*

Chart 2 – March soybeans



Courtesy Reuters

Chart 3 – November soybeans/December corn



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SUGAR

Tightening in the market

The recent weakness in the US dollar provided a boost to many commodity markets. The energy complex did not participate, because traders continued to focus on falling demand. Crude oil and natural gas prices proceeded to new lows. Troublesome for sugar bulls is the fact that sugar has been behaving more like an energy market than a food market. This reaction is based on the assumption that ethanol usage will fall more than consumption of other commodities because it will lose its competitive edge to petroleum products.

This is not completely accurate. The explanation is similar to the one we offered for corn-based ethanol in the US (*Focus on Futures*, December 18), but to a much greater extent. The ethanol industry in Brazil, the world's largest consumer of cane-based ethanol, is fully mature, and demand patterns are likely to be identical to those of other commodities. First, the government mandates a minimum 25% ethanol blend for all vehicles. Even for flex-fuel cars, in which consumers choose the blend, the government controls the spread between petroleum and ethanol price at the pump, so there has been no change in the relationship, even as petroleum prices tumbled.

We therefore continue to believe that the cane crush ratio for the upcoming 2009-10 marketing year in Brazil will remain at historically high levels of roughly 60% favoring ethanol.

There have been no major developments in the sugar market, but whatever information has surfaced has been bullish.

On December 22 the Indian government lowered its estimate for 2008-09 sugar output to 20 million tonnes, the low end of the range provided in its previous forecast of 20.5 to 22 million tonnes. Production in 2007-08 was 26.3 million tonnes.

In mid-2007 – following the spike to 20¢ per pound when farmers were inspired to plant huge crops – sugar prices collapsed to 8.5¢ per pound. To reduce burdensome inventories, India eliminated export licenses. Now, in a sign that the sharp drop in output has authorities concerned, the government has reinstated the requirement to obtain export permits as of this coming January 1.

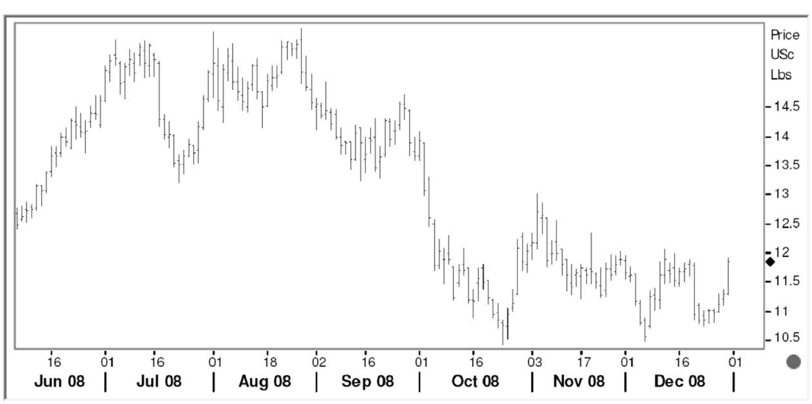
The population of India is growing at a rate of 1.38% per annum, and with it demand for commodities is surging, particularly for staples such as sugar. One estimate puts domestic consumption for 2008-09 at 25 million tonnes, a fantastic jump over the 21 million tonnes of recent years. This would draw Indian inventories down to about 6 million tonnes, well below the comfort level that central planners have allowed in the past. Not only does this eliminate the possibility of exports in the coming years, it opens up the strong possibility of India becoming a net importer. Although most analysts have a bearish bias on commodity prices and are reluctant to make forecasts that would indicate the beginning of a recovery, most agree that India will be a net importer of about 1 million tonnes over the next 12 months.

We've now swung completely from a huge surplus of 9.4 million tonnes in 2007-08 to a deficit. Czarnikow revised its estimate for the 2008-09 global deficit, from 3.3 million in August, to 5.8 million tonnes.

The future is not bright. Brazilian farmers are not profitable with world sugar prices at these levels. Cost of production has been rising. Although it is impossible to pinpoint the actual average cost of production in the diverse regions of Brazil, we are trading at or near the cost of production, which leaves farmers little or no profit with which to invest in expanding and improving their crops. With prices at these levels, we are unlikely to see Brazilian output increase by any appreciable amount in the 2009-10 season.

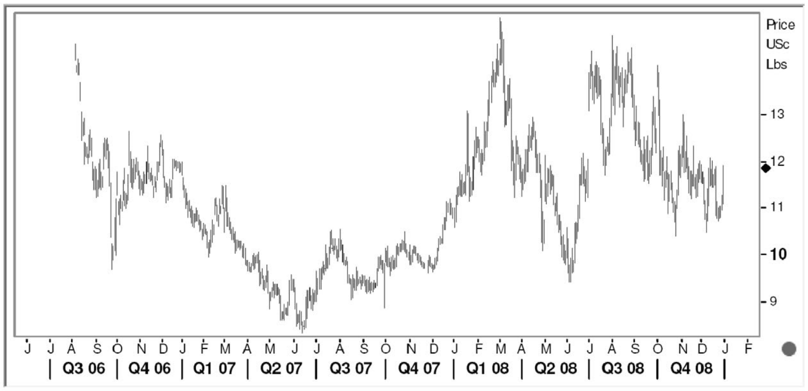
Use the recent weakness in sugar prices, facilitated by the market's treatment of sugar as an energy product, to add to long positions. *[December 31, 2008]*

Chart 4 – March sugar



Courtesy Reuters

Chart 5 – Weekly sugar



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COTTON

Demand shrivels, but so does supply

Market activity in cotton has been almost identical to that of all commodities during the financial crisis: dramatic gains followed by massive liquidation (Chart 6). Currently, it is among the commodities that put in a bottom in November. Still, these markets have fallen by so much in such a short period of time that rallies could be viewed as corrections to deeply oversold conditions.

The liquidation of any stale long positions in the cotton market is technically complete in that open interest has fallen to below the level it was at before the bull market began (Chart 7).

In our previous discussion of cotton (*Focus on Futures*, November 3) we cautioned traders not to be too alarmed by tumbling US mill consumption. US manufacturing and mill usage is compensated for by exports. While this was true – and will continue to be true at some point – the rate of mill consumption has declined beyond what would be reasonable to account for the shifting manufacturing base, *and* exports – which were performing well given the economic crisis – have all but ground to a halt.

According to Census Bureau statistics, average monthly mill usage has been 341,894 bales since the 2008-09 marketing year began on August 1. This is down 10.8% from the comparative period last season. The USDA lowered its estimate for annual mill usage to 4.3 million bales in the December supply/demand situation report, but this represents a drop of only 6.7% from last year.

On the export front, at the end of November we were still chugging along ahead of last year's pace, but we've now fallen behind. As of the most recent export report, commitments for 2008-09 stand at 7.77 million bales, compared with 7.96 million bales at this time last year.

The USDA has been slashing its forecast for annual exports. The estimate peaked at 15 million bales in September, with the most recent reading at 12.25 million bales. Weekly US export commitments have been averaging about 100,000 bales during December, nowhere close to the level required to meet even the reduced estimate for the season. Using the US export market as a proxy for world demand, consumption patterns both in the US and abroad are bleak.

So should we be selling the rally? Not a chance. Producing countries began cutting back output in 2008-09 and are likely to continue planting more profitable crops when the 2009-10 planting season begins this spring.

The reduction in US acreage this season is legendary but well known, and indeed, well planned in a sense because of the sharp reduction in demand. The US harvested only 13.61 million bales, down from 19.21 million bales in 2007-08. There have not been any acreage estimates for 2009-10, but it's no contest when comparing historical profitability ratios with any of the other major US crops. Where farmers have the choice, they will not plant cotton (Chart 8).

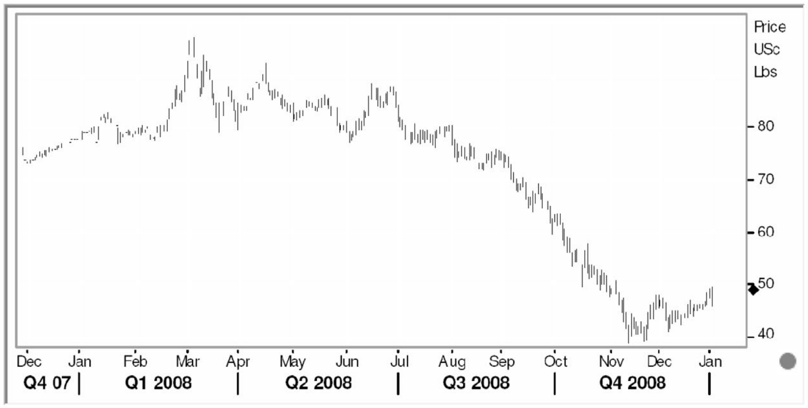
Among the top global producers, Chinese acreage for 2009-10 is estimated to be down at least 10%, with some forecasts calling for far deeper cuts.

The USDA reduced 2008-09 Indian output by 1 million bales in its December report, to 24 million bales. With close to half the crop harvested, however, arrival levels indicate that production will reach only 20 million bales.

At the time of the recommendation offered on November 3 to "...hang on if you're long," March cotton was trading at 49¢ per pound. After a gut-wrenching drop to below 40¢ per pound, we're back to the 49¢-per-pound level. It's impossible to predict an improvement in demand. But it is clear that the world supply situation will be extremely vulnerable if there is any uptick in demand. Stay long.

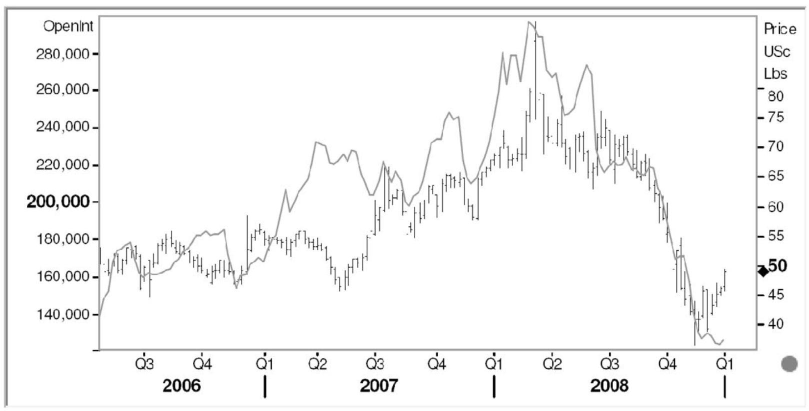
[January 5, 2009]

Chart 6 – March cotton



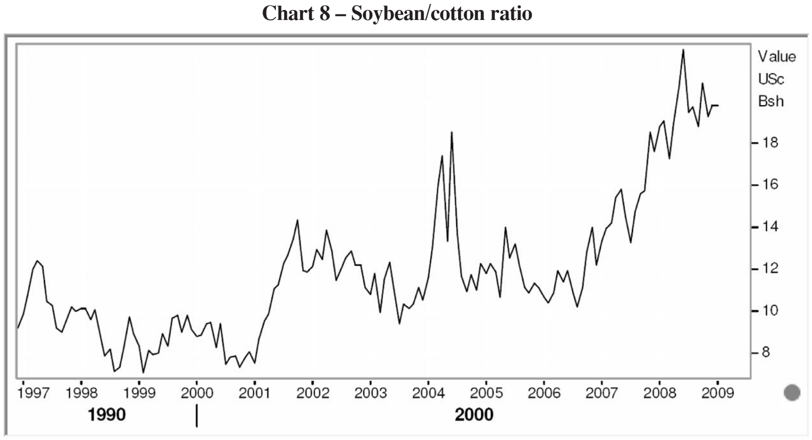
Courtesy Reuters

Chart 7 – Weekly nearest contract (bar), Open interest (line)



Courtesy Reuters

Chart 8 – Soybean/cotton ratio



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