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Hot, dry weather in the Midwest threatens size of the US corn crop

This month's USDA supply/demand situation report, released on July 11, was an all round disappointment for corn bulls. In the days before the release of the report, US crop weather was improving, and the market was already selling off, erasing the bulk of the weather rally. The bearish report looked certain to bring early closure to the annual weather event in the trading pits. But forecasts for hot, dry weather appeared just a day later. The market action over the following two weeks actually turned into quite a disappointment for bears, with September corn challenging levels not seen in the spot month since May 2000 (Chart 1).

The highlights of the report included a 4.5-million-tonne increase in 2001-02 ending stocks, most of which consisted of a revision to Chinese stocks, a 5-million-tonne increase in 2002-3 Chinese output, and of course, the 3.56-million-tonnes upward revision to the forecast for the US crop, to 248.68 million tonnes (9.79 billion bushels).

Although the US figure was only 8 million bushels above the average analyst's estimate (to put that in perspective, that's a fraction of one week's worth of export sales), the street was genuinely surprised, because the hot, dry weather in the US Midwest had been badgering the crop. The estimate for 2002-03 production, however, was based on an increase in the forecast for harvested acreage to 72.1 million acres from 71 million acres in the June report. Yield was left unchanged at 135.8 bushels per acre, indicating that deteriorating crop conditions were not factored into the equation.

We can safely assume that the USDA production figure is well behind the reality of current conditions. Since the June 24 weekly crop rating report, the good-to-excellent portion of the crop has fallen to 42% from 62%. Last year, at this point of the growing season, the good-to-excellent portion of the crop stood at 59%.

The following rough calculation shows what the crop would look like if crop conditions do not improve. In other years in which drought affected the corn crop, such as 1988-89, 1993-94, and 1995-96, the average ratio of harvested-to-planted acres was 87.6%. The USDA's current estimate uses a 91.4% ratio, slightly above the average of the past few (non-drought) years.

The average yield in those drought years was 99.4 bushels per acre. The USDA maintained its June estimate of 135.8 bushels per acre, also the average of the past few (non-drought) years.

Let's be conservative and say that farmers will harvest 89% of planted acres, or 70.22 million acres. Let's assume a yield equal to the 1997-98 yield of 126.7 bushels per acre, the most recent moderately poor crop. This would give us a crop of 8.897 billion bushels, or 225.8 million tonnes, compared with the USDA's 9.79 billion bushels, or 248.68 million tonnes. Plugging the results of this model into the global balance sheet, we find a dramatically different picture than the one painted by the USDA. Shaving 22.88 million tonnes off the US crop estimate would bring global ending stocks down to 91.86 million tonnes, 14.7% of consumption, compared with the

In this issue

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USDA's 114.74 million tonnes, or 18.3% of consumption. This would be the lowest carryout in modern history.

Some other notes that could affect prices: Old crop US exports have slowed down over the past couple of weeks, but commitments are on track to meet the 2001-02 USDA estimate of 48.9 million tonnes. The USDA lowered its estimate for US exports for 2002-03 from its June estimate by 640,000 tonnes, to 52.07 million tonnes, anticipating, perhaps, the growing threat to US exporters from China.

The USDA kept its forecast for Chinese exports at 6 million tonnes, but according to press reports, this figure should probably be in excess of 8 million tonnes. Ideas of increased availability of corn for export are consistent with the dynamics of the country's supply/demand balance. Domestic consumption has grown to 127 million tonnes this year from 120 million tonnes in 2000-01. Output, however, has exceeded this growth rate by a wide margin, having grown to 125 million tonnes from 120 million tonnes in 2001-02 and 106 million tonnes in 2000-01. While the production/consumption deficit will continue to draw down inventories, the depletion is modest in terms of the country's still burdensome stockpile of 57 million tonnes, representing 45% of consumption. We can expect China to continue to pose competition to US exports. Normally, this would have a negative effect on prices, but if drought conditions in the US prevail, the impact would be overwhelmed by the drop in supply.

In conclusion, the weather in the US Midwest is really the only game in town. All bets would be off if precipitation patterns were to return to normal. If, however, drought conditions prevail, we will see a much smaller crop and much higher prices. *[July 24, 2002]*

STRATEGY: *Remain long December corn. Raise stops to 228, close only.*

Chart 1 – Weekly spot corn

Courtesy Reuters

WHEAT

Production forecasts continue to erode

Wheat prices have soared to levels not seen since March 1998 (Chart 2).

When the marketing year began in June, analysts believed that global wheat production was set to break the four-year trend of falling output. Recent developments, however, have ruled out any such notion. In this month's supply/demand situation report, the USDA slashed its June estimate for global output by 9 million tonnes, to 580.72 million tonnes, still a small increase over last year. The cuts to the output forecast were not nearly deep enough.

More current estimates from major producers have become available since the USDA's July report, which change the global ending stock picture significantly. The poor climactical seeding and growing conditions we had in the US have not been discriminatory and have been quite hard on wheat crops around the globe.

The 23-million-tonne output estimate for the Canadian wheat crop is based on the 3% reduction in acreage for the 2002-03 crop. The principal growing regions in Western Canada have had drought conditions similar to the US, and it is therefore difficult to believe that the crop will be any bigger than last year's 21.3 million tonnes.

The effect on Australian production has been particularly severe. The USDA is way out of line on this one. It maintained its June forecast of 23 million tonnes. On July 23, government forecaster ABARE lowered its forecast to 18 million tonnes from its June estimate of 20.5 million tonnes.

Finally, the US attaché in India lowered its forecast for Indian production by 500,000 tonnes, to 71.5 million tonnes, compared with the USDA's 72 million tonnes.

These reductions total 7.2 million tonnes, which draws 2002-03 global ending stocks down to 139.88 million tonnes, or 23.54% of consumption, compared with the USDA's 24.75%. At the end of 2001-01, stocks stood at 27.33% of consumption. The USDA's first estimate of 2002-03 stocks in May was 27.22%, so these bullish developments have altered the landscape considerably.

Some argue that the strength in wheat prices is, to some degree, tied to the weather rally in corn and – at times – there is some validity to this reasoning. There is a psychological connection between the agricultural markets, which has something to do with the close, physical proximity of the trading pits at the Chicago Board of Trade. This, of course, makes no economic sense. But there *is* a widely watched corn/wheat ratio. Almost all the corn grown in the US is used as livestock feed, while wheat is grown for human consumption. Some wheat can be fed to livestock when it becomes cheap enough relative to corn. If corn prices are strengthening relative to wheat prices, traders will close the gap by buying wheat to bring the ratio into line. In the current environment, however, wheat prices are much stronger than corn (Chart 3) and even after a correction are trading at 1.38 times the price of corn, near the high end of the range for the ratio. This indicates that bullish wheat fundamentals must have a life quite their own.

The weather in the US Midwest is not nearly as large a factor for wheat as it is for corn and soybeans, because – as of this past Monday's crop progress report – 82% of the winter wheat crop had already been harvested. Also, spring wheat – given present forecasts – represents only 32% of the total crop.

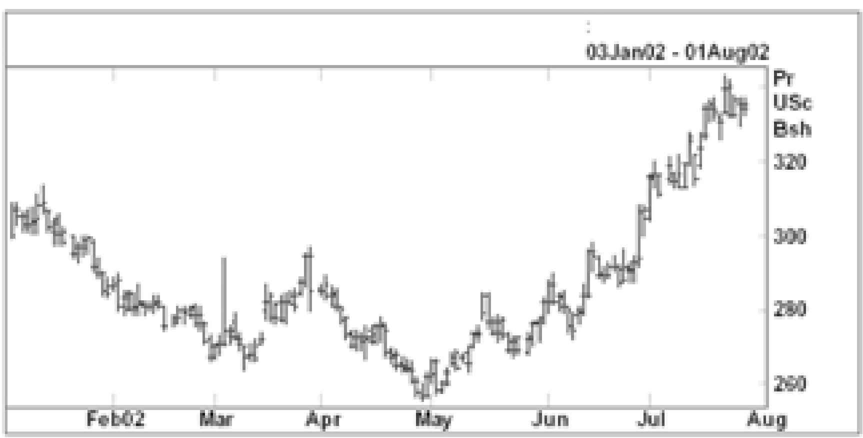
Although the winter wheat output will be 13% smaller than last year's crop, that information has been around for some time now and is already "in the market." Unlike corn and soybeans, the USDA has already accounted for the poor growing conditions of the winter and spring wheat crops by lowering its forecast for US output by 2 million tonnes from its June estimate.

Spring wheat regions have definitely been affected by the dryness. The most recent crop progress report shows only 38% of the crop in good-to-excellent condition, down a notch from the previous week, but down dramatically from last year at this time when the top category represented 63% of the crop. The estimate for spring wheat will almost certainly be trimmed again in the August crop report, because some regions have suffered from the hot, dry conditions that have plagued the Midwest this season.

Weather market or not, the continuous decline in global wheat production finally seems to be catching up to the market. The summer weather gyrations are just putting some gloss on the rally. *[July 26, 2002]*

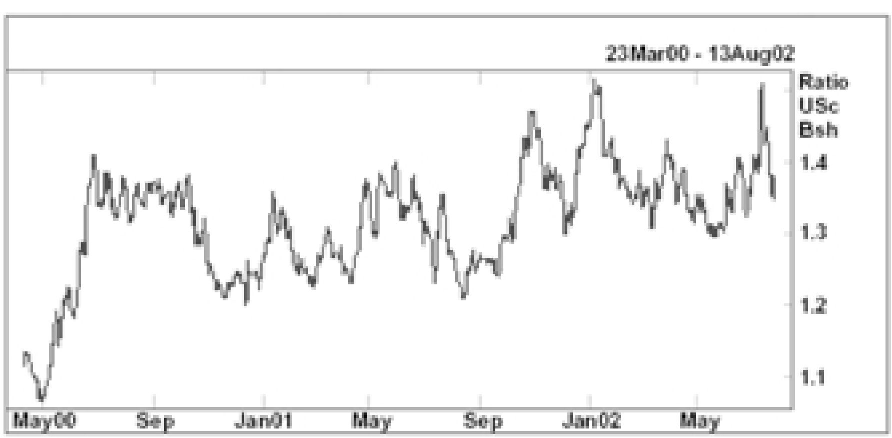
STRATEGY: *Remain long December wheat. Maintain stops at 302, close only.*

Chart 2 – Weekly nearest contract



Courtesy Reuters

Chart 3 – Wheat/corn ratio



Courtesy Reuters

SOYBEANS

Is wet weather creating a buying opportunity?

Forecasts for some wet weather in the principal soybean growing regions this past week sent prices into a rather severe, 55¢-per-bushel nosedive. The bullish case for soybeans, however, does not revolve solely around the condition of the US crop. Prices actually bottomed in January (Chart 4), when issues such as planting intentions and seeding and growing weather were still unknown.

Brazil and Argentina harvested record crops again, which when combined were close to 10% higher than the previous year's output. It is quite amazing that soybean prices were able to rally off their $4-per-bushel lows even as South American supplies were becoming available. Some respected analysts were talking $3.50 per bushel, while few if any spoke of $6 beans.

The two countries grew 66.8 million tonnes of beans in 2000-01, 73 million tonnes in 2001-02, and the USDA forecasts that they will top this in the coming crop year with output of 77 million tonnes. This would be just a smidgeon shy of the US crop currently growing, estimated to be 77.84 million tonnes.

At this rate, the South American duo are likely to displace the US as the world's largest grower and exporter of beans by as early as the 2003-04 crop year. Brazil overtook the US position as the world's largest grower of oranges years ago and sent frozen concentrated orange juice into a bear market from which it has yet to emerge. Even sub-freezing weather in Florida hardly evokes much more than a limp, short-lived rally. Can this happen to the soybean market?

Well, perhaps, but not in the foreseeable future. As we pointed out above, the availability of South American supplies did not seem to create a ripple in the market when we were between Northern and Southern Hemisphere crops. The US – the world's largest exporter (for the moment, anyway) is finishing off the 2001-02 marketing year with ending stocks of 5.72 million tonnes, or 7.1% of consumption. This is lowest carryout since the 1996-97 season, when the US had a scant 3.6 million tonnes of beans (5.4% of consumption) left at the end of the season and beans soared to close to $9 per bushel.

The USDA has made an optimistic assumption. It lowered projected US output for the 2002-03 crop by 272,000 tonnes to 77.84 million tonnes, a relatively insignificant amount in light of the fact that crop conditions are so poor. This past week the good-to-excellent portion of the crop dropped to 43% from the previous week's 50%. Last year at this time 55% of the crop was rated good-to-excellent. The USDA maintained its June estimate of 39.7 bushel-per-acre yield, which, at present, seems to be a fairly unlikely outcome.

The USDA's mandate is to maintain a high degree of objectivity. There is a weather scare just about every year, and until it is fairly certain that there have been any significant changes, the USDA bases its forecasts on trendline yields. Having said that, if current conditions do prevail, we can assume that yields will be closer to other drought-year yields, such as 1996-97 in which farmers harvested 37.6 bushels per acre. With a projected harvested area of 72 million acres, the crop would reach only 2.702 billion bushels (73.68 million tonnes). This would leave US ending stocks at 1.96 million tonnes, or an alarmingly low 2.5% of consumption.

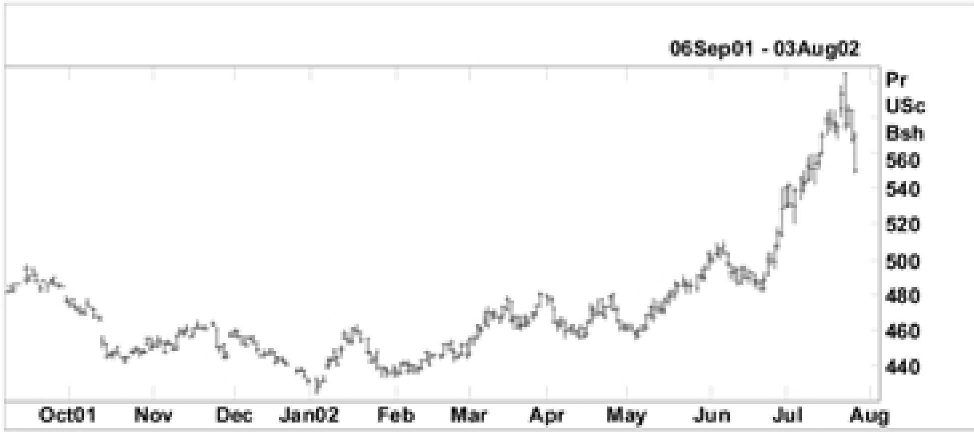
On the demand side, it is a bit difficult to understand why the USDA lowered its forecast for US exports for 2002-03 by over 2 million tonnes from this past season. With several weeks still to go in the 2001-02 marketing year, US exporters have shipped 27.94 million tonnes of beans, 98.2% of the expected target, which will almost certainly be met and perhaps exceeded. To meet increased demand by growing populations and increasingly Westernized diets, purchases by the Asian Tiger countries have grown each year since 1992-93 with the exception of 1997-98. We don't know of any reason for this trend to end.

The global supply/demand balance is very bullish, even with the USDA's current estimates. The demand side of the balance sheet was very strong long before there was even a hint of trouble from the supply side. In the 2001-02 marketing year global consumption jumped by 11.82 million tonnes, or 6.9%, over the previous season. Production also increased but by only 8.64 million tonnes, or 4.9%. This coming season, usage is forecast to grow by 6.54 million tonnes, or 3.5%, while output will increase by 5.65 million tonnes, or 3.1%. Global stocks will be drawn down to 29.37 million tonnes, 15.4% of consumption. If the USDA overshot on the US crop and underestimated export demand, we will have the lowest carryout in modern history.

Beans are still very cheap in historical terms (Chart 5) and as illustrated, carry potentially explosive bullish fundamentals. We remain sidelined but are carefully considering whether the selloff caused by forecasts for rain is presenting an opportunity to enter the long side. *[July 28, 2002]*

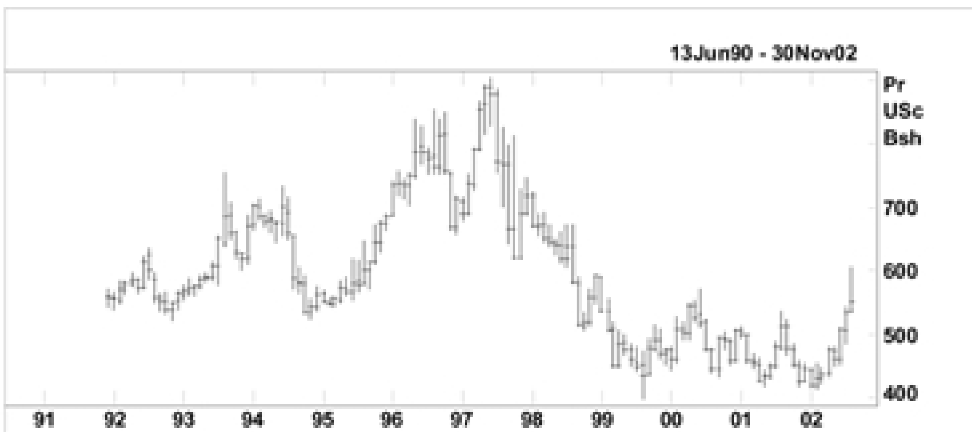
STRATEGY: *Remain sidelined, but closely tuned.*

Chart 4 – August soybeans



Courtesy Reuters

Chart 5 – Monthly nearest contract



Courtesy Reuters

COCOA

The bull that just won't quit

On July 24 we liquidated our long cocoa position. September cocoa had plunged over $100 per tonne from the $1,843-per-tonne high, and we felt confident that an (interim) top was in. Not 24 hours passed, and the bull came charging back with a rally that made up most of the losses of the previous few sessions (Chart 6). Where do we go from here?

The fundamentals have not changed very much. Besides, who would know anyway. There is so little useful information available for this market. The indicators that we find reliable seemed to be telling us that the market was running out of steam. Over the years, we've found that a buildup in open interest with no progress in price has been an excellent indication that a trend has come to an end – at least temporarily.

After such a strong move in price, it is assumed that commercial traders that use the commodity in question have anticipated the need to build their inventories and have done their buying at more favorable price levels. Speculators are the last ones in, and the stagnant price action is an indication that they do not have the power to move the market any further.

The other important factor that helped form our decision to exit the market was the erosion of the backwardation that has accompanied this bull market from the start. The most recent leg of the bull run, which began in mid-June at $1,500 per tonne, saw the 1-year spread drop from an eye-popping $250 per tonne (Chart 7) to the current flat market.

We believe that these two arguments are quite logical and brought us to exercise the prudent course of action.

Nevertheless, we can find holes in our own arguments as detailed below and are therefore not closing the books on this bull market.

First of all, it is difficult to ignore how this market reacts to bearish news. German and US second-quarter grind figures were both below the low end of traders' expectations. The German grind was 24% lower, and the US was down 19%. The US melting figures were up sharply, however, indicating that there is solid demand by end users. We are still waiting for the delayed pan-European figures.

Another factor: While the spreads in New York have fallen apart, the spreads in London are still quite strong (Chart 8). The London Commodity Exchange has more stringent guidelines for deliverable grade, which means that there is more demand for higher-quality beans. If there is *bona fide* tightness at the higher end, it spills over to the entire market.

The open interest issue is not that simple either. The bull case was never taken seriously by large or small speculators. Aside from a short-lived buying spree earlier this spring, commodity funds have carried only modest net-long positions and have been net short for the last $300-per-tonne rally (Chart 9). Small speculators have been whittling down their net-long position since the bull market began (Chart 10). The small spec group now has an uncharacteristically small net-long position for this stage of a bull market.

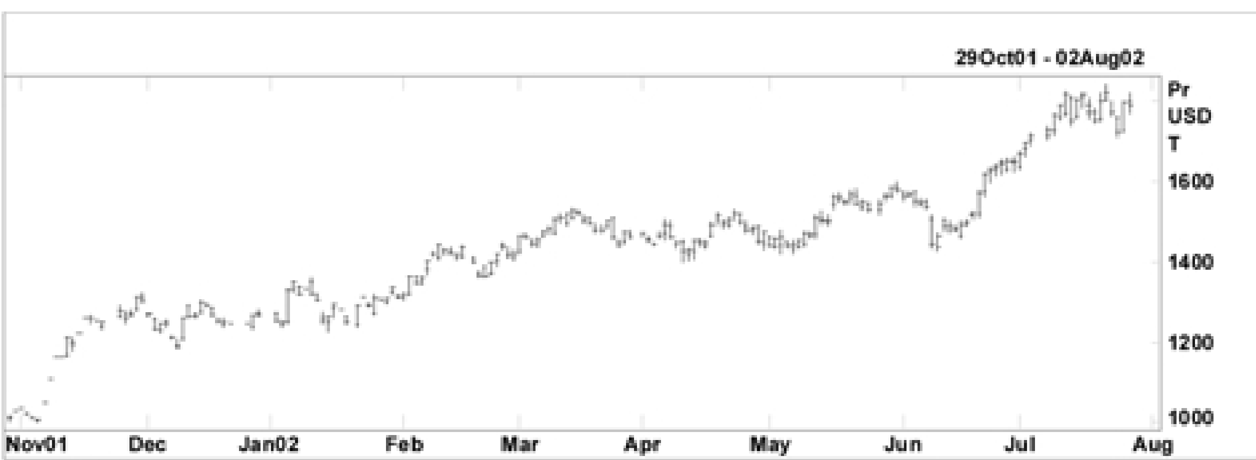
As we've pointed to many times, the principal issue was and remains the size of the Ivorian crops. We have seen very little in the way of estimates for the new, 2002-03 crop. One respected analyst put the main crop at 1 million tonnes, which would make the total crop about the same size as the 2001-02 crop of 1.2 million tonnes. E.D.&F. Man has not released any reports since April, and that is something to look forward to in a market with such a dearth of information.

In conclusion, while the strong melting data don't score headlines the way the grind figures do, we believe that it is a strong indication that consumption of chocolate is very strong. Grindings are low because of the poor profit margins, but someone is buying cocoa beans, or prices could not maintain such strength. If speculators are not doing the buying, then it must be commercial interests.

Are we feeling a bit uncomfortable being out of this market? Well, yes. But it was hard to ignore our disciplinary guidelines. We continue to watch very closely. Stay tuned.
[July 29, 2002]

STRATEGY: *Liquidated long September cocoa as per Flash Update of July 24.*

Chart 6 – September cocoa



Courtesy Reuters

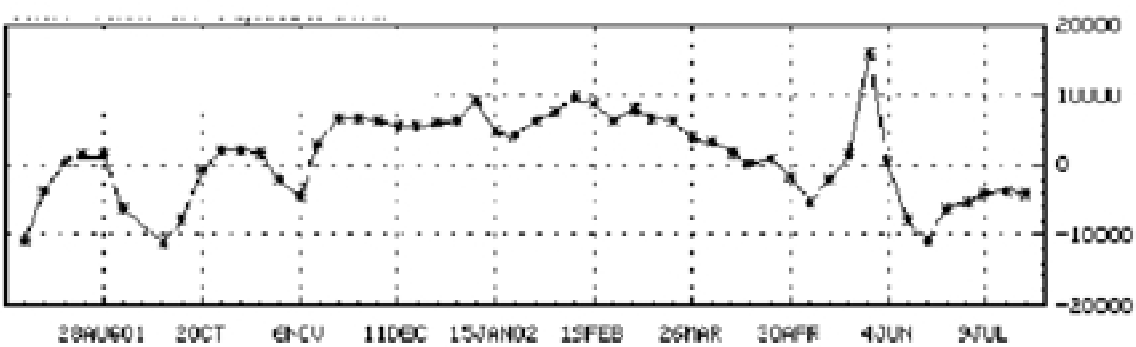
Chart 7 – New York 1-year spread

Courtesy Reuters

Chart 8 – London 1-year spread

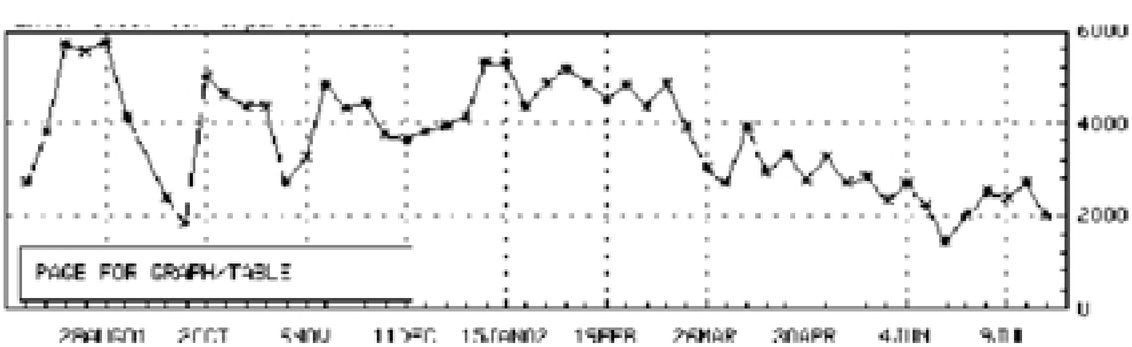
Courtesy Reuters

Chart 9 – Commodity fnd net position



Courtesy Bloomberg L.P.

Chart 10 – Small speculator net position



Courtesy Bloomberg L.P.

HOTLINE UPDATE

Friday, July 5, 2002:
Good afternoon for Friday July 5, 3:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are short September mini S&P, with our stop revised to 1050; long September cocoa, with our stop at 1425; long December corn, with our stop at 215; long December wheat, with our stop at 285; and long August gold, with our stop at 306. All stops are close only.

Friday, July 12, 2002:
Good afternoon for Friday July 12, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are short September mini S&P, with our stop revised to 1010; long September cocoa, with our stop revised to 1555; long December corn, with our stop revised to 222; long December wheat, with our stop revised to 302; and long August gold, with our stop at 306. All stops are close only.

Friday, July 19, 2002:
Good afternoon for Friday July 19, 4:20 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are short September mini S&P, with our stop at 1010; long September cocoa, with our stop revised to 1565; long December corn, with our stop revised to 228; long December wheat, with our stop at 302; and long August gold, with our stop at 306. All stops are close only.

Flash Update – Wednesday, July 24, 2002:
Good morning for Wednesday, July 24, 11:50 am. This is a Flash Update. We have liquidated our long September cocoa position at 1715.

Flash Update – Friday, July 26, 2002:
Good morning for July 26, 9:40 am. This is a Flash Update. We have liquidated our long August gold position at 306.

Friday, July 26, 2002:
Good afternoon for Friday July 26, 4:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are short September mini S&P, with our stop revised to 860; long December corn, with our stop at 228; and long December wheat, with our stop at 302. All stops are close only.

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