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US soybean crop developing into a major disappointment

The June 30 USDA acreage report showed that US farmers planted 74.533 million acres of soybeans this spring. This figure was 260,000 acres below the March 31 planting intentions report and 276,000 acres above traders' average guesstimates. Considering the volatility we've seen in soybean prices over the past three months (Chart 1), the acreage number has been fairly stable. Although the estimate was *higher* than expected, November new-crop beans greeted the report with a new contract high settlement of $15.74 per bushel.

Although the devastating floods in the US Midwest affected both corn and soybean areas, the estimate for corn acreage was unexpectedly high (more on corn later this month). It was widely believed that at least some of the abandoned corn acres would be planted with soybeans, which can be planted after the planting window for corn is closed. However, the relatively low estimate for soybean area surprised the market.

The most likely explanation is that soybean prices were much higher relative to corn when the original USDA survey was conducted before planting began. But the current acreage estimate was based on surveys conducted throughout May and early June, when corn prices strengthened dramatically versus soybeans, but before the effects of massive flooding could be accounted for (Chart 2). Although the USDA indicated that there would be additional tours in the weeks leading up to the release of the June 30 acreage report, analysts seem to agree that it is unlikely for acreage to be as large as reported. With soybean prices moving to historic highs, this certainly seems to be the view of the market.

Moreover, the June 10 monthly crop report – in a rare move for this early in the season – lowered the estimate for corn yields, because of inclement weather, but left soybean yields unchanged from the May estimate. But it is fairly clear that a potentially significant amount of the soybean crop was affected as well. We expect that it is near impossible for the July 11 monthly crop report not to lower the 84.5-million-tonne (3.105 billion bushel) estimate for the US crop.

With the South American crop now available – sort of – this time of year should see the soybean market amply supplied. But despite a record crop of 61 million tonnes in Brazil and a near-record crop of 47 million tonnes in Argentina, the multi-month series of farm strikes – which are in protest of an export tax – has crippled the export market and has had an appreciable impact on Argentinean exports. Some exporters have imported beans from Brazil to honor shipping contracts, but the amount of beans coming out of South America is down sharply. While this story has dominated soybean headlines, it is actually the smallest problem for this market, because it is temporary. Beans that are withheld eventually come back into the system.

After a season in which global consumption of 233 million tonnes outstripped production of 218.8 million tonnes, we can ill afford another drawdown. Even with a very early forecast for continued growth of South American output in 2008-09, the USDA is forecasting a balanced market. And besides, the next South American crop will not be harvested for another year. For a while it appeared that this bull market had overextended, but there is nothing to indicate that prices have risen high enough to bring sufficient supply to the market.

Concerning trading strategy, on May 12 we issued a half-hearted buy recommendation, but a firmer long soyoil/short soybean spread recommendation to capture the effects of the growing bio-diesel market on the soybean market (Chart 3).

Inside

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: *ssanik@friedberg.ca*).

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The timing for the spread idea was poor, because it seems that the high price of beans has made bio-diesel too expensive relative to petroleum-based diesel, resulting in lower-than-expected usage. To reflect lower-than-expected soyoil usage, the USDA lowered its estimate for US methyl ester usage for 2008-09 in the June report by 100,000 pounds, to 3.1 million pounds. In any case, the bio-diesel market will continue to grow, and we feel comfortable suggesting the spread as an excellent trade at these levels.

[July 2, 2008]

Chart 1 – November soybeans

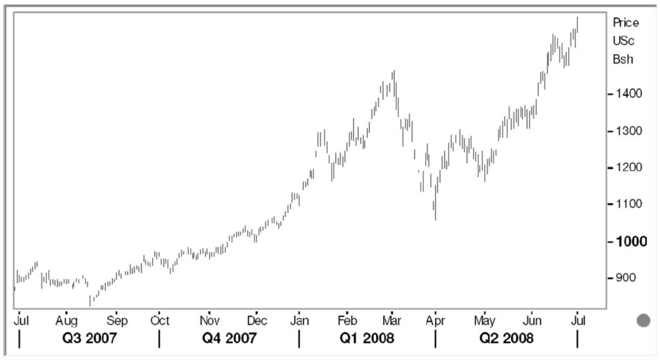

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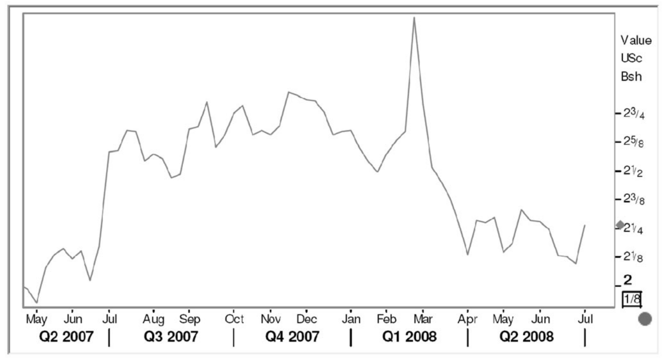
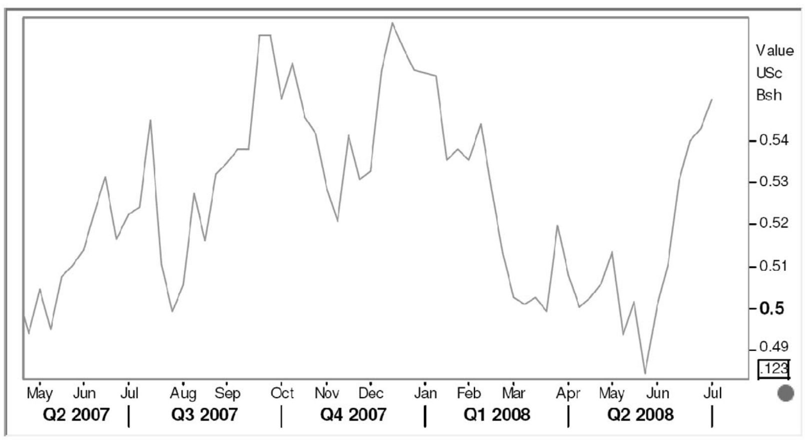
Chart 2 – Soybean/corn ratio



Courtesy Reuters

Chart 3 – Soybean/soyoil ratio



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COCOA

What burdensome inventories?

The cocoa market took a sharp selloff into the July 4 holiday and resumed with an even sharper selloff when traders returned to work after the weekend (Chart 4).

While there continues to be little doubt that part of this powerful run has drawn strength from the broad commodity bull market, it is also clear that the supply/demand fundamentals are bullish. Analysts have made only minor adjustments to their global balance sheet forecasts, but in all likelihood those estimates do not adequately reflect all recent bullish developments.

Most supply-side news focuses on the three large West African producing nations, whose combined crops account for roughly 70% of global output. Indonesia is a significant producer, though, typically accounting for more than 15% of total global production, and its crop is struggling with disease. In 2007-08 the crop reached 570,000 tonnes. When the main-crop harvest for 2008-09 began in March, the acreage-based forecast was 520,000 tonnes, so that's already been in the market for a while. But the spread of traditional as well as unfamiliar pests has trimmed forecasts further throughout June, with estimates as low as 480,000 tonnes. One report claims that 60% of plantations are affected by one disease or another. The government has reportedly responded with significant allocations for fighting the crop diseases, but sal-

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vaging the well-advanced main crop may be too late for this marketing year.

Back in the Ivory Coast, after the usual season-long noise about too much rain and then not enough rain, the crop looks about average. The arrival figures are higher than last year, but we have to bear in mind that the main-crop harvest began about one month early, and the mid-crop is likely to end early as well.

In Ghana, the world's second largest producer, estimates have climbed through the season and are now slated to come in at the high end, about 700,000 tonnes.

The real story is demand. Grinding data have shown that global consumption has been growing at about 4% per annum, which is probably slightly higher than the rate of production growth. For many years, the bearish story in the cocoa market was burdensome carryover stocks. Current LIFFE warehouse stock data show that over the past year, inventories have fallen by about 20%. LIFFE warehouses are not necessarily representative of all cocoa inventories, but if we were to assume they are a reasonably reliable proxy, then global carryover stocks are more in the neighborhood of 25% to 30% of consumption, rather than the 35% to 40% range we worked with in recent years. It is estimated that readily available supplies of beans for grinders is about three months' worth of supply, where two years' worth was the industry standard until a couple of years ago.

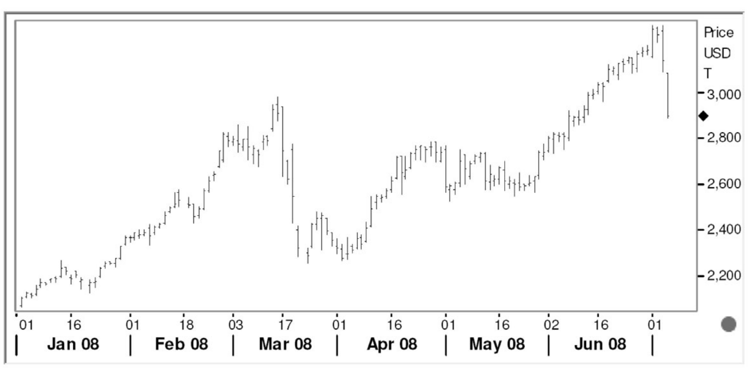
So while the so-called hard data – grindings and butter ratios – indicate strong demand, they are obviously incomplete. We seem to be running available supplies down at a much faster rate.

In exploring the issue of the degree to which explosive runup in prices is related to the weak dollar and excess liquidity, we find that while open interest in cocoa has moved up with prices, it has been fairly well contained. Chart 5 shows that the rally earlier this year took open interest to record highs, but the correction in March cleaned out weak longs. The level of open interest remains moderate relative to the increase in price.

Analysis of most commodity markets is incomplete without the Chinese angle. Cocoa has been an exception to this rule over the years, because the Chinese were just not chocolate eaters. That may no longer be the case. We make the rough estimate that imports of cocoa beans and products have grown to the bean equivalent of 50,000 tonnes per annum. A recent news report put the annual growth of chocolate consumption in China at 10% to 15%. We've never discussed the Chinese cocoa market, because up until recently it was insignificant. The implication of a continuation of this trend speaks for itself.

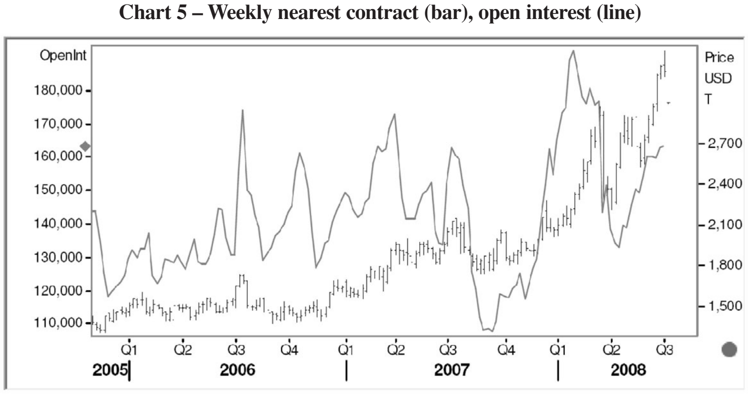
Use these sharp setbacks to establish fresh long positions and to beef up portfolios that are underinvested in this powerful bull market. *[July 7, 2008]*

Chart 4 – September cocoa



Courtesy Reuters

Chart 5 – Weekly nearest contract (bar), open interest (line)



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SUGAR

Fading surplus

The dramatic fall from the bull market peak that just nicked the 20¢ per pound level in early 2006 culminated with the recently expired July contract taking a brief dip below10¢ per pound.

Most sugar analysts draw the conclusion that sugar prices are going nowhere – down if anywhere – because the global surplus for 2007-08 has grown, and they are forecasting a surplus for 2008-09, albeit a much smaller one.

For example Kingsman's most recent estimate raises the 2007-08 surplus to 11.34 million tonnes from 9.13 million tonnes, and moves the 2008-09 surplus up to 3.29 million tonnes from 2.86 million tonnes. Czarnikow pegs the 2007-08 surplus at 11 million tonnes and 1.6 million tonnes for 2008-09. Certainly from this point of view it would seem that sugar prices may have even overextended in the current rally.

However, the very same issues that we've been harping on all year continue to move in a bullish direction. While we do indeed have a large surplus for the outgoing marketing year – larger than *we* expected – we believe that surpluses are not sustainable.

First, the erosion of the food-to-fuel ratio of the Brazilian sugar cane crop is staggering. Estimates now have the ratio at 62/38 in favor of ethanol. In our last article on sugar (May 9) we quoted that ratio at 57.5/42.5, and we thought that was pretty exciting for bulls. Little wonder, with crude oil trading at $135 per barrel. Exacerbating the problem is that the tail end of the harvest has seen excessive rain, which will lower sugar content.

Then we look at the world's second largest producer, India, and we find that the large crops of the past couple of seasons may have been an anomaly. On July 3 the farm ministry released its acreage estimate for the new crop, showing a much-larger-than-expected 17% drop from last season. Analysts that are forecasting a surplus for 2008-09 are still using estimates for Indian production based on a repeat of the 26-million-tonne output of 2007-08. But it should be obvious from the acreage estimate that more recent forecasts for the new crop in the 21-million-tonne zone are more accurate.

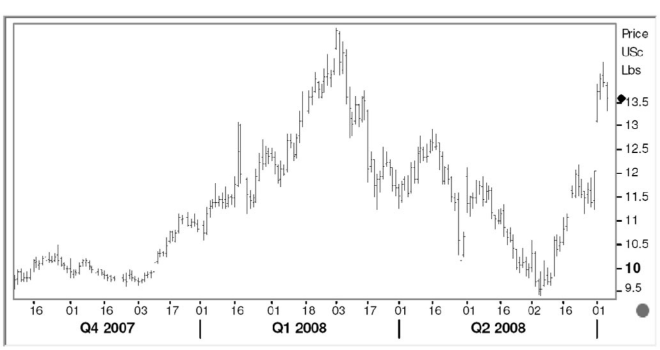
Indian exports reached over 4 million tonnes in the 2007-08 marketing year, but with domestic consumption at an estimated 22 million tonnes, it is quite reasonable to assume that the government could revert to its imposition of protectionist export tariffs to keep supplies at home. It's hard to imagine that India could move from huge production/consumption surpluses to a deficit, but that is now a distinct possibility.

Looking ahead, with sugar prices lagging the strength in the broader commodity markets and with a strong real, Brazilian export revenues are stagnant and have left producers with little inspiration to expand acreage or invest in sugar mills. In a report released on July 7, F.O. Licht raised its global production estimate for 2007-08 by 1 million tonnes, but said 2008-09 output would fall by 6 million tonnes, most likely to account for the Brazilian and Indian factors cited above.

Open interest has shed close to 300,000 contracts since the beginning of the year, or about 25% of total open interest. The month-old rally has – thus far anyway – failed to attract a fresh slate of speculative longs, somewhat of an oddity for the sugar market. At 136,000 contracts, the net-long fund position is still fairly large, but has actually shrunk over the course of the rally.

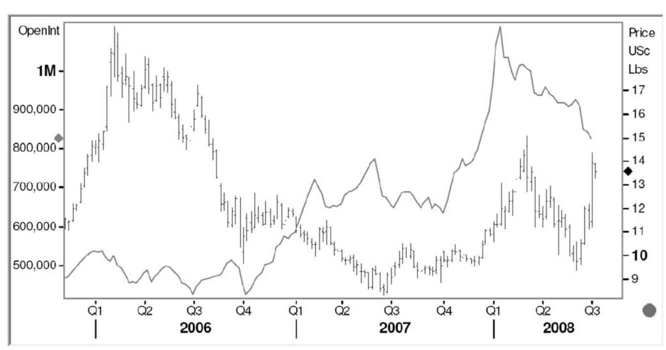
We believe this market is undervalued because of solid bullish fundamentals lurking beneath the surface. Remain long. *[July 7, 2008]*

Chart 6 – Nearest contract sugar



Courtesy Reuters

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



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CORN

Is the bull gone?

The much anticipated June 30 USDA acreage report altered the landscape of the corn market. We do see surprises in the widely watched USDA reports on occasion, but this was a big one. Most market participants were fairly confident that US corn acreage would be slashed from the March 30 estimate of 86.014 million acres. After all, the bulk of the planting season had excessive precipitation, which hampered farm activity, and it was assumed that some acres were lost to flooding during June.

Not even close. The estimate came in at 87.327 million acres, well above the average street guesstimate of 85.661 million acres. To complicate the matter for bulls, the accompanying quarterly stock report showed that June 1 US inventories stood at 4.028 billion bushels (102 .2 million tonnes), well above the average guesstimate of 3.894 billion bushels (98.8 million tonnes), and compared with June 1, 2007, stocks of 3.553 billion bushels (90.2 million tonnes).

Of note, Informa Economics' June 20 projection came within a whisker of the actual number, with its guesstimate of 87.399 million acres. Most other analysts listed by the news wires were not even in the same ball park. Very impressive.

Not looking to endorse Informa – or anyone for that matter – we mention this because the same analyst released a revised yield forecast on July 7 of 152 bushels per acre, up from the USDA's June estimate of 148.9 bushels per acre. Using the new acreage estimate and Informa's yield, the US crop would be 12.002 billion bushels (304.6 million tonnes), compared with the USDA's June estimate of 11.735 billion bushels (298.08 million tonnes).

Actually, Informa's estimate is on the conservative side because the harvested-to-planted ratio of 91.6% used by the USDA in the June report would actually yield yet another 170 million bushels (4.3 million tonnes), but it would seem that Inform is factoring in some abandonment.

Having recorded a fresh all-time high for corn prices in the session prior to the release of the acreage report, the market's limit-down reaction was predictable. The market rallied for a couple of days, but the selling resumed as weather in the Midwest over the July 4 holiday weekend turned perfect.

All these crop and inventory revisions, if accurate, would add about 400 million bushels (10 million tonnes) to global production for 2008-09 and put global production/consumption back into balance rather than previously forecasted deficit. That is the way things look at the moment.

Even so, global 2008-09 ending stocks would improve to about 14.25% of consumption, compared with the June estimate of 13%, but would still be lower than 2007-08 ending stocks of 15.5% of usage. Until ethanol came along in a meaningful way over the past few years, global ending stocks averaged well over 20% of consumption. The US farmer certainly showed far more exuberance in planting than most analysts believed, but we have still not solved the dilemma of how to share the US corn crop with the ethanol market and bring global inventories back to a comfortable level.

While this is definitely a setback for bulls, the crop has all summer to grow and remains vulnerable to weather. The weather might be great, but there is a further vulnerability. The USDA slashed its forecast for US exports in its initial estimates for the new marketing year and then cut the estimate further in the June supply/demand situation report to 50.8 million tonnes, down from a record 62.23 million tonnes in 2007-08.

While it is certain that price has been rationing demand to some degree, there is little evidence that such a large drop export estimates is warranted. With close to two months left in the marketing year, we are fairly close to meeting the record sales forecast by the USDA. Commitments stand at 60.01 million tonnes, with 51.3 million tonnes shipped. Average weekly shipments need to average about 1.17 million tonnes, and we've been running slightly behind that pace over the past month or so.

We cannot see the improved prospects for the US crop to be the solution to the tight market that allowed prices to rise this far in the first place. We continue to advise maintaining conservative long positions and exercising caution in adding to existing positions or establishing new ones.

Remain long. *[July 7, 2008]*

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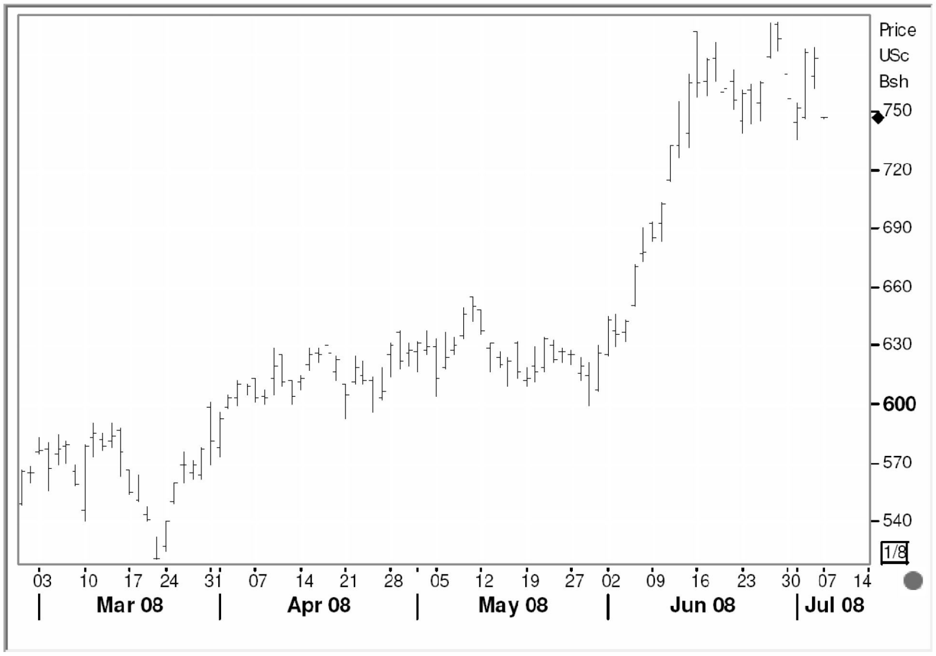
Chart 8 –December corn



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