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A rocky road for corn stats, but the bull stays the course

The USDA has taken corn-market participants on a roller coaster ride these past few months. The first acreage estimate for the 2011-12 crop in March surprised the market with a higher-than-expected forecast of 92.178 million acres. Although US corn area was slated to expand by 4.6% over the previous year, planting-season weather was challenging and after a few days of selling, the bull market resumed regardless (Chart 1).

Normally, the USDA does not revise acreage in the June crop report, but uses the March intentions figure to calculate production estimates until the June 30 update is released. In response to some horrible planting conditions, however, which included massive flooding and potential lost acreage, the USDA slashed the acreage estimate in its regular monthly crop report by 1.5 million acres, or 1.6%. The market traded up to new record highs, but the rally was short-lived. The reaction to that report turned out to be the (temporary?) peak. Prices plunged by more than $1.5 per bushel over the next couple of weeks.

The unfolding events took an even stranger turn. The June 30 acreage update was widely expected to be a confirmation of the downward acreage revision in the crop report. The USDA indicated a certain urgency in making the rather uncommon mid-month revision when the acreage update was only a few weeks away. As such, the average guesstimate for the June 30 figure was 90.767 million acres, just a tad above the revised crop-report estimate of 90.70 million acres.

When the USDA actually raised the figure to 92.282 million acres, slightly higher than the March intentions number of 92.178 million acres, traders were completely confused. Even more compelling: that "very bearish" news initially pushed the market to a new low, but that was the low of the correction and the market rallied by well over $1 per bushel over the following two weeks.

That was arguably the most erratic USDA flip-flop we've ever seen.

Traders didn't know what to expect for the July crop report. Incorporating the extremely bearish June 30 acreage and quarterly stocks report, the average guesstimate for 2011-12 ending stocks was for a jump to 994 million bushels, up from 695 million bushels in 2010-11. The actual figure was 870 million bushels.

While the bearish supply-side fundamentals remained intact this time, there were bullish revisions to all demand categories for 2011-12. It's impossible to know if these forecasts will come to fruition, but without a stronger outlook for consumption, carryover stocks would have moved out of bull market territory. Between feed, food, and ethanol, the estimate for domestic usage was revised up by 245 million bushels. This leaves US ending stocks for the upcoming marketing year at 6.44% of consumption.

Without the brighter outlook for the demand side, stocks would have increased to 8.4% of usage. Either way, US inventories are still well below historical norm. In the period between the bull market in the mid-1990s and the current bull market, the average carryover for US corn stocks was 14.8% of consumption. And the US still remains the supplier of last resort, unlike soybeans, for example, where other producing nations have balanced the reliance on US output. In 1996, the US grew 47% of the world's soybeans, but now produces only 33% of the global total. In 1996 the US grew 37% of the world's corn and that figure has now increased to 39%.

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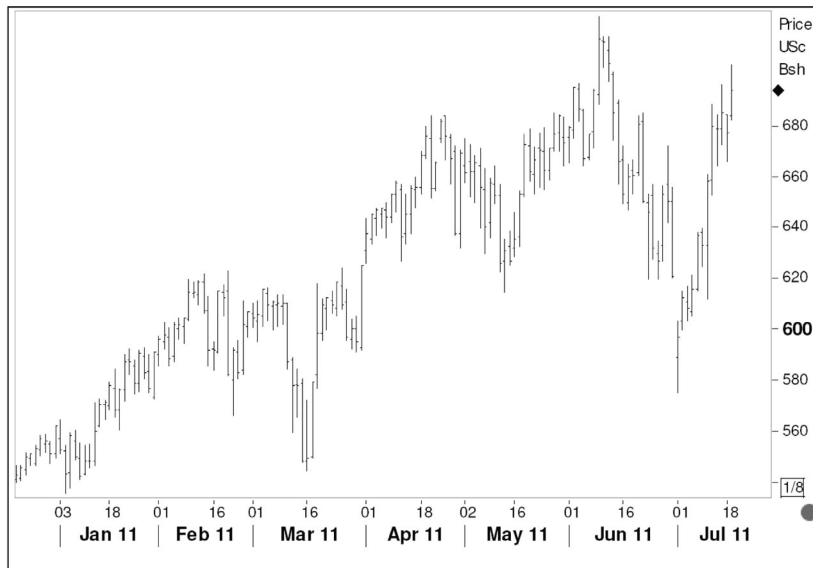
Chinese imports are expected to surge, from 1.5 million tonnes in 2010-11, to 5 million tonnes in 2011-12. Indeed, Chinese importers have been very active lately. The sizeable upwards revision in the estimate for US exports seems to be adequate to account for the news of Chinese purchases. That puts US exports at 48.25 million tonnes, still significantly below the pre-recession mid-decade records, when US corn exports averaged over 55 million tonnes.

Congress is getting serious about repealing the ethanol tax credit enjoyed by producers. It seems bearish, mostly because profit margins will be slashed and reduce incentive to produce. Ethanol usage is well entrenched, however, mainly because the government mandates a minimum ethanol blend into gasoline, which is legislated to grow until 2022. In any case, the subsidies will not be phased out entirely. In addition, as a replacement for part of the revoked subsidies, the government is going to invest in ethanol-specific infrastructure to create broader accessibility, which – it would seem to us – would increase consumer demand, and that's bullish.

Meanwhile, hot and dry weather in the US Midwest has brought corn prices back to just shy of all-time highs. Remain long. *[July 20, 2011]*

Chart 1 – December corn



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COPPER

Should prices be soaring?

The recent bull run in copper prices is not something you would expect to find in the script, given the turmoil in the financial markets.

After skyrocketing to the $4.65-per-pound level in mid-February, copper prices had a sharp correction, falling by more than 15%, before finding support at $3.85 per pound. The stock market continued its ascent through the end of April (Chart 2). The stark divergence was a bit of an enigma because the two markets normally move in unison – give or take. Perhaps the copper market was more prescient than the stock market in foreseeing the potential harmful effects on the global economy that would result from the fallout from the European sovereign debt crisis and the inability of the US Congress to reach an agreement on raising the Federal Government's debt ceiling. But then, copper prices rallied by 40¢ per pound even while the stock market was in the midst of a scary decline. The usefulness of copper prices as a harbinger for future economic conditions looked questionable.

The copper rally gathered steam when rare winter storms hit the copper belt in Chile in late June and early July, causing a complete shutdown for several days at huge mines, including Escondida, the world's largest copper mine. Coupled with ongoing labor disruptions, the slowdown in Chilean output provided the foundation for the current leg of the rally that has brought prices all the way back to the $4.50 level. Is this strength sustainable?

During the recession in 2008, prices fell dramatically (Chart 3) because demand was so weak. As soon as the global economy began to recover in 2009, however, the mining industry could not keep up. Current supply-side trends remain sluggish. Monthly Chilean output data have been directionless, alternating between strong and weak results.

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Overall, average monthly production since the beginning of 2011 is down 0.05%.

Mine output in key producer Indonesia is seen falling by more than 25% this year because ore grade is declining.

While it's quite true that the output problems in Chile – weather and labor – are of a temporary nature, it does highlight the vulnerability of a single region, that provides 30% of world supply.

Chinese demand has carried this bull market, and its survival could hinge on what the future holds for the Chinese economy. Imports have been slumping. The most recent data, released on July 21, showed that month-over-month copper imports for June rose by 19.7%. However, when compared with June 2010 – a more vital barometer of the long-term trend – year-over-year imports fell by 15.9%. Chart 4 shows clearly that, despite the handsome uptick in June, imports have been trending downwards for over a year now.

Analysts use the term "implied demand" when referring to Chinese copper usage, but that is really just import data. As such, demand is falling.

We've drawn attention several times to the phantom stockpile of copper held in bonded warehouses. It is not included in exchange warehouse calculations and is rumored to have grown to as large as 700,000 tonnes. However, the very same sources that have publicized the information about the off-exchange inventories are now saying that the stockpile has fallen by half. This could mean that the copper is actually being used by *bona fide* industrial copper consumers and possibly explains the weak imports that we've seen over the past few months.

The most recent report from the International Copper Study Group's (ICSG), released on July 21, shows that the global copper balance sheet posted a supply/demand deficit of 69,000 tonnes for 2011 through April.

The contango narrowed (Chart 5) during the worst of the weather-related supply disruptions, but has returned almost to its widest level, even while prices are making a run for the all-time highs. Although producers are struggling and the major consuming regions outside of China are compensating for softer Chinese imports, the market seems well supplied.

It's been a powerful move, particularly considering the shaky economic environment we're in. With each visit to the press conference podium on Capital Hill by Senators and Congressmen from either party to report on progress (or lack thereof) of the debt talks, the markets gyrate violently. It's a dangerous trade at these levels. For the bold, sell September copper at the market, but don't risk much beyond the contract highs. *[July 28, 2011]*

Chart 2 – September copper (bar), Dow Jones Industrial Average (line)

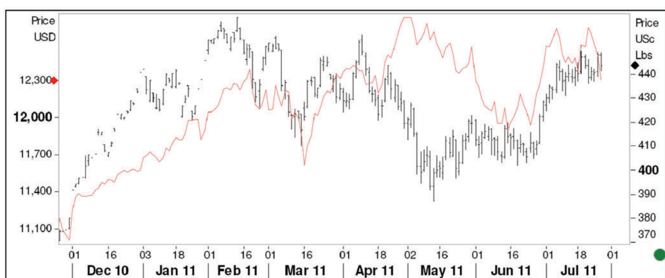

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Chart 3 – Weekly copper

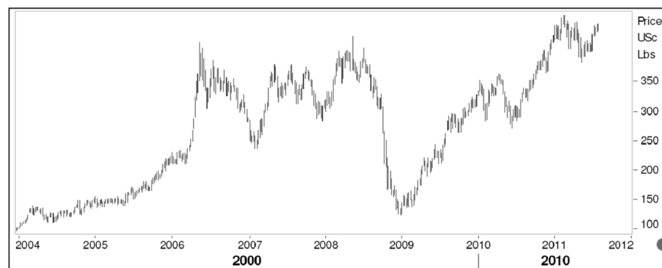

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Chart 4 – China copper imports

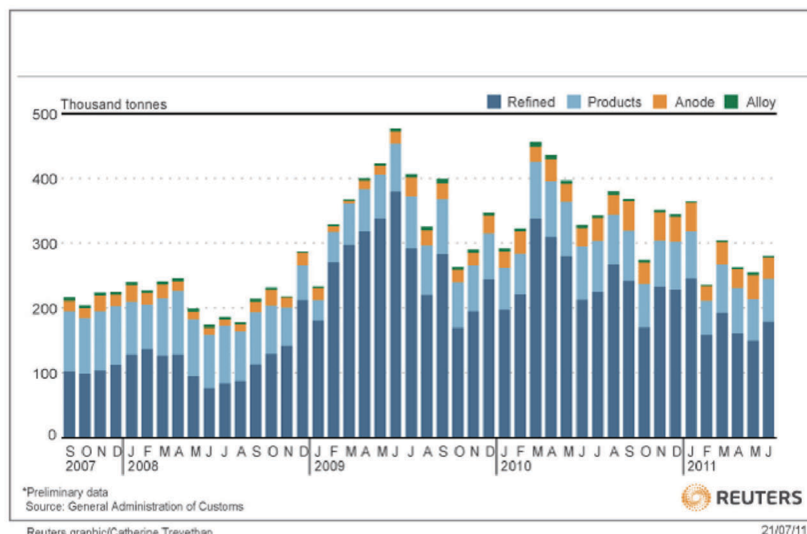

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Chart 5 – September/December copper spread

Courtesy Reuters

SOYBEANS

Is a bull justified?

On June 24, we offered the following, not profitable, but prudent advice: "In conclusion, soybean prices benefitted from the secular bull market in commodities, and more specifically from strength in related markets, such as corn. The fundamentals are not bullish, but it's been dangerous to be short anything, so we are hesitant to recommend an outright short position. Observe from the sidelines." The market is indeed considerably higher. Have the fundamentals changed?

The USDA acreage estimates have been as volatile as the markets themselves. Despite a very wet spring planting season, traders were quite certain that not much US soybean acreage would be lost. Corn, which has a much earlier planting deadline, lost a lot of acres to flooding. It was assumed that this area would be switched to soybeans. The guesstimate for the June 30 planted-area update was 76.53 million acres, down just slightly from the March 31 planting intentions estimate. The USDA surprised the street with a much smaller-than-expected estimate of 75.208 million acres.

Amid a confluence of other factors, not the least of which is the rally in corn prices, soybeans took off. Even after a setback, new-crop November is trading $1 per bushel above the level it was at before the acreage report was released.

Unlike corn, the US is not the supplier of last resort for soybeans. Massive Brazilian and Argentinean crops become available in the spring, just as US supplies from the previous harvest begin to dwindle. In the US, we are now entering the fifth consecutive marketing year with what in historical terms would be considered frighteningly low inventory levels, but perhaps that is the new normal because of the overwhelming growth of South American crops.

The July USDA crop report revised 2011-12 ending stocks to 175 million bushels, down from the June estimate of 190 million bushels. The lower acreage revision alone would have slashed 60 million bushels off the inventory estimate, but bearish revisions to the demand side kept the drop in the carryover at a moderate level. There were downward revisions to the estimates for both 2010-11 and 2011-12 exports.

This revision would leave 2011-12 US ending stocks at 5.4% of consumption, down from 6.1% last year and still near record lows. At mid-decade, ending stocks were averaging 14.2% of usage. However, consider that US output was 85 million tonnes in 2004-05 and has grown by only a negligible amount to 87.77 million tonnes in 2010-11. On the other hand, combined Brazilian and Argentinean production in the 2004-05 season was 92 million tonnes, compared with 124 million tonnes in 2010-11. So, while US ending-stock levels continue to erode, global ending stocks have actually increased from 23% of usage in 2004-05 to 25.9% in 2010-11.

As mentioned above, the USDA has been trimming 2010-11 US export estimates, and the August crop report is likely to cut some more. Weekly shipments have averaged below 200,000 tonnes over the past couple of months. At that rate, with shipments to date at 38.7 million tonnes and six reporting weeks left to the marketing year, we will not make the USDA's current estimate of 40.7 million tonnes.

Aside from smaller-than-expected acreage, the US crop is struggling, and we will not be surprised to see a downwardly revised yield estimate in the August crop report. The most recent crop progress report showed that 60% of the crop was in the good-to-excellent category. That's down from 62% in the previous week and 66% last season.

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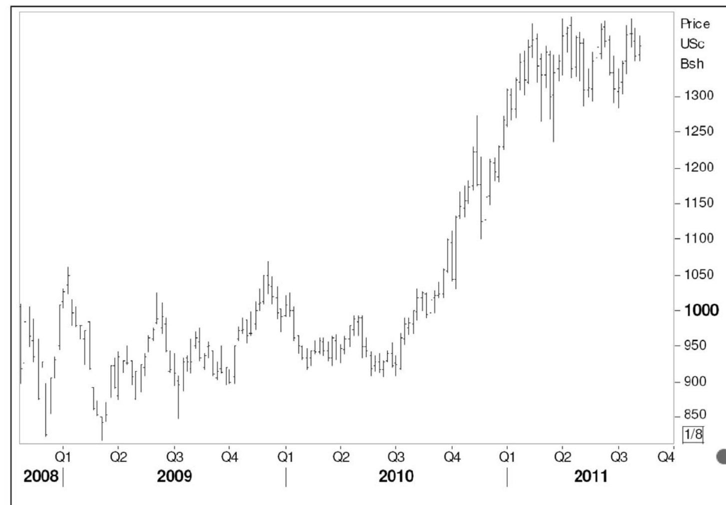
The market has been running into overhead resistance at the $14-per-bushel since early this year. Now that we're near that level once again, the risk of shorting a market that probably has no business being this strong is smaller and more defined. Sell short November soybeans, placing initial stops at $14.25 per bushel, close only.

Chart 6 – November soybeans



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SUGAR

Sweet again

After soaring to 36¢ per pound earlier this year, sugar prices experienced a wicked correction, falling by 40%, to just shy of 20¢ per pound (Chart 7). Expectations for a bumper Brazilian crop, a surprise surge in Thai output, and a broad correction in commodities were the catalysts for the selloff. At the time it seemed that it was lights out for the bull. A rather spectacular rally in June and July took prices right back to 31¢ per pound, dispelling any notion that the bull market had ended.

While prices were falling, so were Brazilian output estimates. Once the harvest began in April, it became clear that inclement weather would reduce yields to lower-than-expected levels. The market was complacent with early forecasts for yet another record crop in Brazil, which at one point was estimated to reach close to 40 million tonnes. Extrapolating from estimates for the Center South region (Chart 8), which produces about 90% of Brazilian sugar and which analysts focus on, 2011-12 output will be just over 37 million tonnes. Some analysts are predicting even lower output. The unexpected 2-million-tonne-plus jump in Thai output should have compensated to some degree, but demand from Russia, Indonesia, China, and the Middle East has been very strong.

Near-term global tightness resulted from the chronic backlog at Brazilian ports that plagues sugar and other export commodities. That has cleared up now. The problem with sugar supply in Brazil, however, runs deeper than overburdened ports and a poor crop.

Early forecasts for a global surplus of 10 millions tonnes were premature and probably steered the Brazilian ethanol/sugar production ratio to higher levels than would comfortably accommodate the country's sugar export commitments.

To little avail, though. Ethanol supplies have become tight as well. Brazil will import about 650 million liters of ethanol from the US this season. That's only about 2.5% of total usage, but highlights the inability of the industry to keep up with demand. It is estimated that automobile sales in the rapidly growing economy is growing by 20% per annum.

The government was toying with reducing the mandated minimum 25% ethanol blend in car fuel to ease the pressure on tight supplies, but has recently abandoned the idea.

Looking ahead, there is little chance that sugar production will capture any significant increase in its share of the cane crop.

Production costs for sugar have risen over the years, another reason that we'd be hard-pressed to see a meaningful drop in the ethanol/sugar output ratio going forward. Over

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the past several years, costs have increased from the low teens to over 20¢ per pound. That's a powerful bullish case for further price gains that would allow prices to rise enough to provide incentive for higher sugar output.

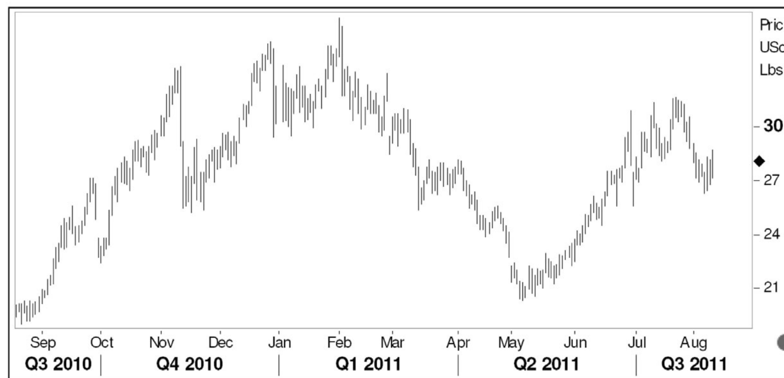
The leap in Thai production has been well known for many months and has obviously not played much of a role in alleviating pressure on the market from the smaller-than-anticipated Brazilian output. For that matter, we believe that with estimates still ticking down, the market has not yet fully absorbed the potential fallout.

The early forecasts for a 2011-12 global sugar surplus in the neighborhood of 10 million tonnes have shriveled dramatically. Estimates are all over the place, but a recent estimate by a statistician at F.O. Licht put the global surplus at a scant 800,000 tonnes.

On May 18, with sugar hovering near the lows of the correction, at about 21¢ per pound, we wrote, "Current price levels present an excellent low-risk opportunity to enter the long side. Buy October sugar at the market. Place initial sell stops at 20.50¢ per pound, close only."

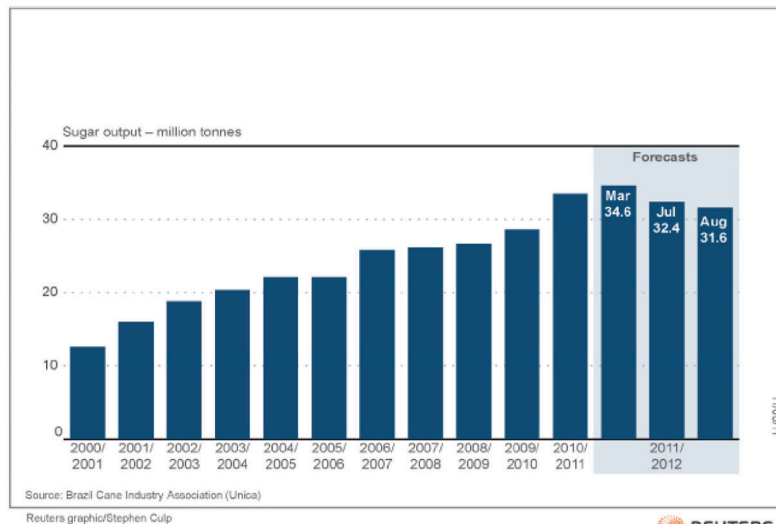
So far so good. Raise stops to 26¢ per pound, basis October, close only.

Chart 7 – October sugar



Courtesy Reuters

Chart 8 – Brazil Centre South 2011-12 sugar output



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