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Can the market for US wheat exports continue to shrink?

This past autumn the US wheat market was in the midst of what we believed was the beginning of a powerful bull market that would last for some time. Prices had finally responded to years of falling global output. Fears of shortages became particularly intense when three of the world's major exporting countries – the US, Canada, and Australia – grew crops that were much smaller than normal. Estimates of global 2002-03 output dropped precipitously throughout the marketing year, from early season forecasts of 595 million tonnes to the most recent estimate of 567 million tonnes. Nonetheless, it turned out that $4 per bushel would not be a sustainable level.

Demand has not contracted, though. On the contrary, global consumption grew to a record 597 million tonnes in 2002-03. In fact, the global supply/demand balance sheet still has the appearance of being quite bullish. The 2002-03 season will mark the third consecutive year of production/consumption deficits, with the largest shortfall by far (28.51 million tonnes) being recorded this year.

Demand for US wheat by foreigners is another story. Overseas shipments for 2002-03 are forecast to reach just 23.81 million tonnes, also the third consecutive season of declines and the smallest export total since the 1985-86 season.

US prices have fallen despite the fact that the US crop in 2002-03 was 9 million tonnes, or 17%, smaller than the previous season's. The US has substantial domestic requirements and, even with its relatively weak export market, maintains its status as the world's largest exporter, albeit by a smidgeon. Ending stocks in the US were run down to 12.64 million tonnes, dramatically below the 21.15 million and 23.85 million tonnes carryover of the past two seasons. Why is the market so weak?

Well, if the pace of global consumption is not in retreat, then the primary issue is competitiveness. Other producing countries – particularly those of the FSU – have taken a lot of business away from the US. FSU exports in 2002-03 jumped by 10 million tonnes, or 70%, to 23.66 million tonnes.

To illustrate the magnitude of this development, consider that only two seasons ago, in 2000-01, the US exported 29 million tonnes of wheat compared with FSU exports of a scant 5 million tonnes. Even with a tumbling US dollar and after a price decline of more than 25% from the peak set last September, US wheat of comparable quality has been expensive enough to drive traditional customers away.

Some recent international trade – which in the past might have gone to the US but went to competitors – highlights the dilemma. On March 5, Jordan purchased 100,000 tonnes from FSU and other European countries, while Egypt bought 260,000 tonnes from France. Trade talk in the days before the transactions took place had both the Jordanian and Egyptian purchases going to the US.

Average export commitments over the past four weeks have sunk to 250,000 tonnes per week, compared with 315,000 tonnes in the previous 4-week period. With only 13 weeks left in the marketing year, US exporters must sell just over 4.5 million tonnes, or about 350,000 tonnes per week, to reach the USDA target for the year of 23.8 million tonnes.

Although it is be a bit premature to be forecasting the size of 2003-04 crops, it does seem, based on early acreage estimates, that output will recover. The estimates we've heard

Inside

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have ranged between 586 million and 606 million tonnes.

The USDA estimated that US acreage will increase by 3 million acres and that yields will improve by 4 or 5 bushels per acre. It is difficult to imagine a repeat of the carnage caused by inclement weather to the Australian and Canadian crops, so we have to assume that these two countries will snap back as well.

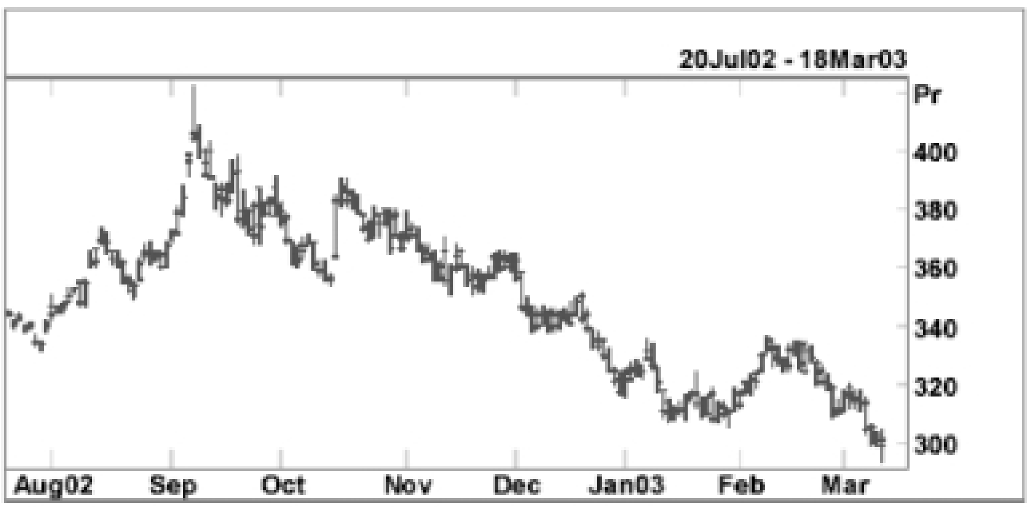
We've presented the bearish case. But prices have already come down, and we maintain a slight bullish bias for several reasons. A combination of falling US prices and a strong euro have brought US and EU prices back into line. French spot milling-wheat is trading at the equivalent of $118 per tonne, roughly the same as May Kansas City hard red winter wheat. The price edge that other exporters had is all but gone. Of course, FSU and Eastern European wheat is much cheaper, but much of those sales are intended for feed.

US farmers are not very optimistic. Although their planting intentions indicate a crop that will be 28% larger that the 2002-03 crop, it is still a small crop by historical standards. Export demand could indeed remain sluggish, but if it were to pick up as prices become more attractive, we would have to look back at the 2002-03 US ending stock picture. Even after this month's upward revision, stocks of 12.64 million tonnes, or 23% of consumption, are the lowest they've been since the mid-1990s.

This may be adequate given current conditions, but there is no doubt in our minds that if the market were to improve for US exporters, there would not be sufficient supplies to readily meet the needs of foreign buyers. At that point, $3-per-bushel wheat will look ridiculously cheap. *[March 13, 2003]*

STRATEGY: *Remain sidelined, but stay tuned.*

Chart 1 – May wheat



Courtesy Reuters

COCOA

Is the bull market in cocoa over?

The political unrest in the Ivory Coast has not made many market-moving headlines lately. A cease-fire is in place, and a power-sharing coalition government is being established, which will be represented by all the warring factions, including the rebel groups. It is far from clear whether this experiment will work. So far, ministers from several groups have refused to participate in the process to protest the exclusion of their agendas.

In any case, the relevance of the civil strife to cocoa prices is not nearly as great now as it was during the growing and harvest seasons. In fact, the 2002-03 main crop made it out of the country in unexpectedly smooth fashion. The leg of the bull market that stretched from $1,700 to $2,400 per tonne was inspired by fears that plantations were being abandoned by migrant workers fleeing for their lives and that shipments to port would be hampered, with at least some of the crop being destroyed or spoiled.

Although information about the size of the crop is volatile and unreliable, it now seems that the worst-case scenario did not materialize. On March 3, a government official said that the combined total of the main- and mid-crops would reach only 900,000 tonnes. Industry sources, however, reported in early February that port arrivals of main-crop beans alone had exceeded 900,000 tonnes, roughly the same as the previous season's arrivals at that juncture.

After adding whatever arrivals came to port after the release of the February arrivals data and a mid-crop of 150,000 tonnes, E.D.&F. Man's December estimate for an

Ivorian crop of 1.17 million tonnes does not look as unattainable as it did then.

As for the implications of a breakdown of the fragile peace, traders don't have to worry about the effects of warring factions roaming the countryside until the 2003-04 crop is ready to be shipped, and that won't happen until October. With the need for a fear premium gone for the moment, it would not be unreasonable to assume that the market may be overpriced at these levels.

Yet, the market has not fallen apart, and we believe there are several reasons for this. While the amount of beans that made it to port seems impressive in light of the civil war that raged across the country, little is known about the quality of the beans that were shipped. Throughout the harvest season, press reports pointed to the potential for poor quality as farmers rushed the drying process in an effort to get their product to port ahead of any violence.

Frankly, we don't know much about how much of the crop may have been affected. If, however, there was enough damage to the beans to lower butter content significantly, the traditional method of measuring cocoa output by weight would tell us little about the value of the beans to chocolate manufacturers.

This is merely a theory, because we don't have any evidence to back it up. However, we find it intriguing that price support is being provided by the commercial rather than the speculative community. The most recent Commitment of Traders report shows that commodity funds are heavily short this market and are increasing this position with a net short position of 20,797 contracts.

This equals the group's large net-short position back in November, when they drove prices down to $1,700 per tonne from $2,400. Their call on the market was wrong, however, and the market traded all the way back to the $2,400-per-tonne highs.

This does not mean that they have to be wrong again, but it certainly does mean that if supply/demand fundamentals are more bullish than seems apparent, a short-covering rally will be all the more dramatic with such a large speculative short position.

The International Cocoa Organization published its estimates for the 2002-03 season on March 19. It showed that global production grew 21,000 tonnes, or .07%, to 2.874 million tonnes. Grindings, on the other hand, despite the steady flow of negative or flat grinding data we saw all through the season, increased by 100,000 tonnes, or 3.5%. This will leave a production/consumption deficit of 120,000 tonnes, drawing stocks down to1.015 million tonnes, or 34.2% of consumption. This compares with 2001-02 ending stocks of 1.135 million tonnes, which represented 39.4% of consumption. This estimate is in line with previous estimates.

Along with the calm in the Ivory Coast, the market plunged in mid-February owing to the release of some estimates for the coming 2003-04 season. Early and very optimistic output estimates – based largely on an estimate for a 200,000 tonne increase in Ivorian production – put world output at over 3.2 million tonnes. Given the various problems that plague the Ivory Coast, including aging trees and the uncertainty of the civil war, we find it very difficult to accept that this can be achieved.

As illustrated above, it makes perfect sense for speculators to take the position that these prices are unsustainable. But despite several stabs at the bottom of the current range, prices have not been able to penetrate the $2,000-per-tonne level convincingly. As we've noted many times over that past year or so, we believe that Ivorian production has peaked. Certainly, the performance of the crop in the past several years, even before political tensions had any direct bearing on growing or shipping of beans, seems to bear that out (Table 1).

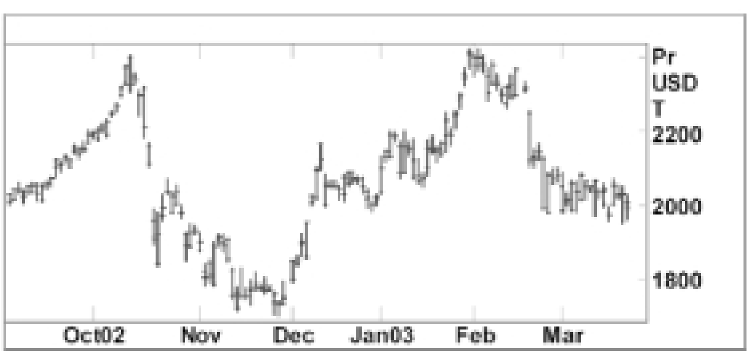
Table 1
Ivorian output (millions of tonnes)

1998-99	1.16
1999-00	1.30
2000-01	1.18
2001-02	1.24
2002-03	1.17

Even with modest consumption growth, global inventories are being whittled away. The risks that this pattern will continue to draw stocks down to the dangerously low 30%-of-consumption level are formidable. *[March 24, 2003]*

STRATEGY: *Remain long July cocoa as per Flash Update of March 19. Maintain initial stops at 1840, close only.*

Chart 2 – Nearest contract cocoa



Courtesy Reuters

CORN

Prices are falling, but some pockets of tightness persist

Many important aspects of the corn market have changed significantly since the first estimates of supply and demand for the 2002-03 season emerged last spring. For the most part, the changes have been bearish for US prices, and market action has reflected this (Chart 3).

During 2002, prices rose to a peak of $2.85 per bushel in September from below $2 per bushel in May. But the rally ended just as the US harvest was getting underway. After a very dry summer, a late surge in yields turned what first looked like a rather poor crop into a respectable harvest. Final yields were 130 bushels per acre, up from pre-harvest estimates of 125 bushels per acre. In addition, estimates for US 2002-03 exports dropped precipitously throughout the season, from 53.3 million tonnes at the beginning of the marketing year to the March USDA estimate of 44.5 million tonnes.

The impact on inventories of a better-than-expected crop and a shrinking export market was significant. Estimates for ending stocks grew from 18.5 million tonnes in September, or 9.4% of consumption, to the current estimate of 25.5 million tonnes, or 12.8% of consumption.

It wasn't that global trade as a whole faded, just that US market-share contracted. Chinese exports, which were estimated at 4 million tonnes at the start of the marketing year, have grown to 12 million tonnes.

A glance at the global inventory situation illustrates that although estimates for ending stocks grew throughout the season, we are still in a relatively tight position when viewed in a historical perspective. Global ending stocks increased from a marketing year low of 90 million tonnes, or 14.5% of consumption, in September to the current level of 106.58 million tonnes, or 17.2% of consumption. This compares with 2001-02 ending stocks of 132.5 million tonnes, or 21.4% of consumption, and 2000-01 ending stocks of 153.91 million tonnes, or 25.4% of usage.

Ending stocks have been falling for years, and despite the improvement over the past few months, carryover stocks are still the lowest they've been since the mid-1970s when the average percentage of stocks-to-usage ran in the low teens.

The market has been making new lows, and things look pretty ugly. A series of important US reports are due to be released on March 31, including the quarterly stocks report and 2003-04 acreage estimates. Analysts estimate that about 80.5 million acres will be planted to corn, which compares with last year's 79.1 million acres. Even after the late-season recovery, 2002-03 yields of 130 bushels per acre were below the 135-bushels-per-acre average yield of recent years. If the Midwest experiences relatively decent weather and the ratio of harvested to planted acreage is normal, we should be looking at a record crop of over 10 billion bushels (250 million tonnes).

There are several interesting bright spots we could point to, although none are enough to construct a bullish case at this juncture.

First, with prices moving back towards the $2-per-bushel range, traders seem to have discounted a perfect crop with no supply or demand surprises accounted for.

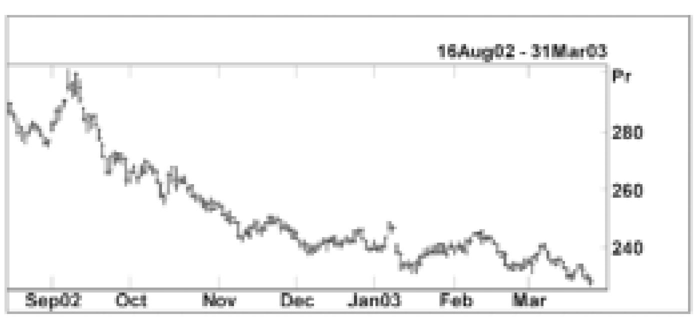
US exports have been recovering lately. Average export commitments over the past 4 weeks have jumped to just under 1 million tonnes per week, compared with 555,000 tonnes for the previous 4-week period. There's a long way to go to the end of the marketing year on August 31, and the market has definitely not factored in a return to a more typical weekly sales figure of closer to 1 million tonnes. Perhaps the effects of a weak US dollar are kicking in.

Although one wouldn't know it from the dive in the futures market, the cash market is tight in the Midwest, with spot prices trading healthy premiums to the May contract.

Finally, as always, the speculative effect helps to exaggerate the underlying fundamentals. Commodity funds have moved from a net-long position of 100,000 contracts last fall to a net-short position of 37,000 contracts. They've certainly bet astutely and we're not about to second guess the winning team. We are going to bear in mind, however, that global ending stocks are at modern-history lows, making the market vulnerable to any glitches in either side of the supply/demand balance sheet. *[March 26, 2003]*

STRATEGY: *Stand aside.*

Chart 3 – May corn



Courtesy Reuters

SOYBEANS

The threat of South American beans flooding the market has not hurt prices, yet

While its sister commodities at the Chicago Board of Trade continue to fall, soybeans stubbornly maintain their poise, just shy of the $6-per-bushel level. The two principal issues that will continue to influence the direction of this market remain South American output and seemingly insatiable Asian demand.

Aside from soybeans, sales of all US agricultural products are lagging last year's pace, which explains why bean prices are so strong relative to the other grains. Consider these soybean statistics: The USDA has edged up its forecast for US 2002-03 exports to 26.13 million tonnes, which is still considerably below final 2001-02 exports of 28.92 million tonnes. As of the last week's export commitment report, sales of beans are running at 25.6 million tonnes, 600,000 tonnes ahead of last year's sales at this time and very close to surpassing the USDA's estimate for the year. Shipments are running at 22.25 million tonnes, slightly ahead of last year's pace of 221.12 million tonnes.

In light of these strong demand numbers, there's a bit of a puzzle about why the USDA has been rather conservative with its export estimates for beans.

The obvious issue that USDA analysts are grappling with is the effect that the beginning of the South American shipping season this spring will have on US exports. Aside from the sheer abundance that is expected to become available from the Brazilian and Argentinean crops, South American beans are priced attractively. The USDA is concerned that there will be cancellations of US commitments once Asian purchasers are confident that South American beans are loaded and sailing to the Orient.

True, commitments can be cancelled. But with 5 months left to the marketing year, shipments represent 85% of bean commitments, compared with only 76% at this time last year. We need to ship only 160,000 tonnes per week to meet the USDA target. If we maintain a normal, seasonal pace, there should be no trouble meeting, and then perhaps exceeding, the USDA estimate.

The problem is that we have yet to experience a situation in which Brazil and Argentina grow more beans than the US. In its March report, the USDA raised its estimate of Argentinean production by 1.5 million tonnes, to 35 million tonnes. This brings combined Brazilian and Argentinean output to 86 million tonnes, which for the first time will surpass US production (74.3 million tonnes). The two South American countries grew 73.5 million tonnes in 2001-02 and 66.8 million tonnes in 2000-01. So "a normal, seasonal pace" of commitments and shipments may have to be redefined in an environment where the availability of alternative supplies is so overwhelming.

Regardless, even if the USDA's assessment of the export outlook is accurate, US ending stocks of 4.34 million tonnes, or 5.8% of consumption, will be the lowest carryover since the mid-1990s, when beans rallied to $9 per bushel.

The argument that low US stocks are not as relevant as they would have been in the past is valid to some degree, but demand is so strong that global ending stocks, which of course include the effect of South American production, are also in a vulnerable position. At 30.44 million tonnes, global inventories represent 16% of consumption, which is below the average of the previous 5 years of 17.3% of consumption.

In conclusion, we exited our long position at current levels several weeks ago because we were concerned that these price levels could not be sustained as we approached the South American harvest. The market's strength is telling us, however, that we were premature in writing off this enduring bull run. So far, rumors of cancellations have been just that, rumors. We are looking at reestablishing a long position.

[March 26, 2003]

STRATEGY: *Stay closely tuned.*

HOTLINE UPDATE

***Flash Update* – Thursday, March 6, 2003:**
Good morning for Thursday, March 6, 9:20 am. This is a Flash Update. We have sold short May sugar at 8.00, placing our initial stop at 9.00, close only.

***Flash Update* – Thursday, March 6, 2003:**
Good afternoon for Thursday, March 6, 1:10 pm. This is a Flash Update. We have liquidated our long May soybean position at 567.5. We repeat our Flash Update of this morning, where we sold short May sugar at 8.00, placing our initial stop at 9.00, close only.

Friday, March 7, 2003:
Good afternoon for Friday, March 7, 4:30 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On March 6 we sold short May sugar at 8.00, and we liquidated our long May soybean position at 567.5. We are currently long April gold at 359, with our stop at 325; long May copper at 76.00, with our stop at 74.50; long May cotton at 57.30, with our stop at 51.50; and short May sugar at 8.00, with our initial stop at 9.00. All stops are close only.

***Flash Update* – Tuesday, March 11, 2003:**
Good morning for Tuesday, March 11, 10:40 am. This is a Flash Update. We have purchased May corn at 237, placing our initial stop at 230, close only.

***Flash Update* – Thursday, March 13, 2003:**
Good afternoon for Thursday, March 13, 1:05 pm. This is a Flash Update. We have liquidated our long May copper position at 74.95.

***Flash Update* – Thursday, March 13, 2003:**
Good afternoon for Thursday, March 13, 2:35 pm. This is a Flash Update. We have liquidated our long April gold position at 335.20. We repeat our Flash Update of this morning, where we liquidated our long May copper position at 74.95.

***Flash Update* – Friday, March 14, 2003:**
Good afternoon for Friday, March 14, 3:35 pm. This is a Flash Update. We have purchased Australian dollars at a 2 month forward price of 0.5951, placing our initial stop at 0.5850, basis spot.

Friday, March 14, 2003:
Good afternoon for Friday, March 14, 4:20 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On March 11 we purchased May corn at 237. On March 13 we liquidated our long May copper position at 74.95, and we liquidated our long April gold position at 335.20. On March 14 we purchased Australian dollars at a 2-month price of 0.5951. We are currently long May cotton at 57.30, with our stop at 51.50; short May sugar at 8.00, with our stop revised to 8.40; long May corn at 237, with our initial stop at 230; and long Australian dollars at a 2-month price of 0.5951, with our initial stop at 0.5850 spot basis. All stops are close only.

***Flash Update* – Monday, March 17, 2003:**
Good afternoon for Monday, March 17, 2:40 pm. This is a Flash Update. We have liquidated our long May corn position at 229.75.

***Flash Update* – Monday, March 17, 2003:**
Good afternoon for Monday, March 17, 4:30 pm. This is a Flash Update. We have liquidated our long Australian dollar position at an all-in price of 0.5888. We repeat our Flash Update of earlier today, where we liquidated our May corn position at 229.75.

***Flash Update* – Wednesday, March 19, 2003:**
Good morning for Wednesday, March 19, 11:40 am. This is a Flash Update. We have purchased July cocoa at 1989, placing our initial stop at 1840, close only.

Friday, March 21, 2003:
Good afternoon for Friday, March 21, 4:30 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On March 17 we liquidated our long May corn position at 229.75, and we liquidated our long 2-month Australian dollar position at an all-in price of 0.5888. On March 19 we purchased July cocoa at 1989. We are currently long May cotton at 57.30, with our stop at 51.50; short May sugar at 8.00, with our stop at 8.40; and long July cocoa at 1989, with our initial stop at 1840. All stops are close only.

Friday, March 28, 2003:
Good afternoon for Friday, March 28, 4:20 pm. The following is a recap of our latest recommendations and stop levels. We are currently long May cotton at 57.30, with our stop revised to 53.00; short May sugar at 8.00, with our stop at 8.40; and long July cocoa at 1989, with our stop at 1840. All stops are close only.

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