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Sweet corn

The corn market was riding the coattails of the bull market in wheat, or so some analysts would have us believe. Everyone will agree that more immediate bullish developments in the wheat market superseded those of the corn market over the past three or four weeks, but none of the top analysts predicted the revision to the 2006-07 US crop contained in the USDA's October supply/demand situation report released on October 12.

Weekly crop condition reports showed that the good-to-excellent portion of the US crop had been steady throughout the past 4 weeks at 61%, compared with 57% last year at this juncture of the season. With improved yields but reduced acreage, output was shaping up to be about the same as last season. The average analysts' guesstimate coming into the report was 11.137 billion bushels (bb), or 282.66 million tonnes (mt), up from the September estimate of 11.114 bb (282.3 mt) and compared with 2005-06 production of 11.112 bb (282.26 mt). The low end of the range of guesstimates was 11.072 bb (280 mt).

So when the report showed that the all-important post-growing/pre-harvest estimate was revised down to 10.905 bb (276.78 mt), it was indeed quite a shock. December corn had already closed at new contract highs in the days preceding the report, but the market tacked on an additional 14¢ per bushel and has since moved well above $3 per bushel – the first time spot prices have reached these levels since summer 2004.

Further examination of the effect that the new estimate will have on the balance sheets reveals just how tight the corn market has become. It shows US ending stocks at 25.29 mt, or 8% of consumption, a steep drop of close to 6 million tonnes from last month's estimate of 31 mt, or 10% of usage. Stocks are already below inventory levels of 2003-04, but prices are just shy of levels reached in 2004. The lowest stock level in modern history was in 1995-96, when ending stocks sank to 5% of usage, and prices skyrocketed to $5 per bushel.

While stocks have not been depleted to that extent quite yet, the next surprise may come from the ethanol sector of the market. Although crude oil prices have fallen sharply, ethanol remains competitive as long as crude prices remain above $45 per barrel. The USDA forecast for the portion of the US corn crop that will be consumed as ethanol stands at 2.15 bb (545.57 mt), but recent usage trends could be an indication that consumption may very well be higher (see *Focus on Futures*, September 5). Some analysts are estimating consumption at 2.8 bb (71.07 mt) for 2007-8.

At the global level, we'd have to go back to the hyperinflation years of the early 1970s to find the corn market in such an extraordinarily tight position. The drop in the US output estimate and a 4% increase in the estimate for global usage push the forecast for global ending stocks down to 89.54 mt, or 12% of consumption, a rather dramatic fall from the outgoing marketing year's inventory level of 124.55 mt, or 18% of consumption.

The US is the only significant exporter of corn in the world. US exports are estimated at 57.15 mt for 2006-07, up from 54.16 mt last year. Argentina is the second largest exporter, with 11.5 mt. Early export sales support the US forecast. This past week's export report showed commitments at 17.71 mt, ahead of last year's pace of 12.715 mt by a wide margin. Shipments are 33% ahead of last year at this time.

We expect corn prices to rise until there is some indication that producers are going to address the issue of expanding demand – particularly from the ethanol side. Remain long and use setbacks comfortably to add to existing positions or to establish new ones. *[October 25, 2006]*

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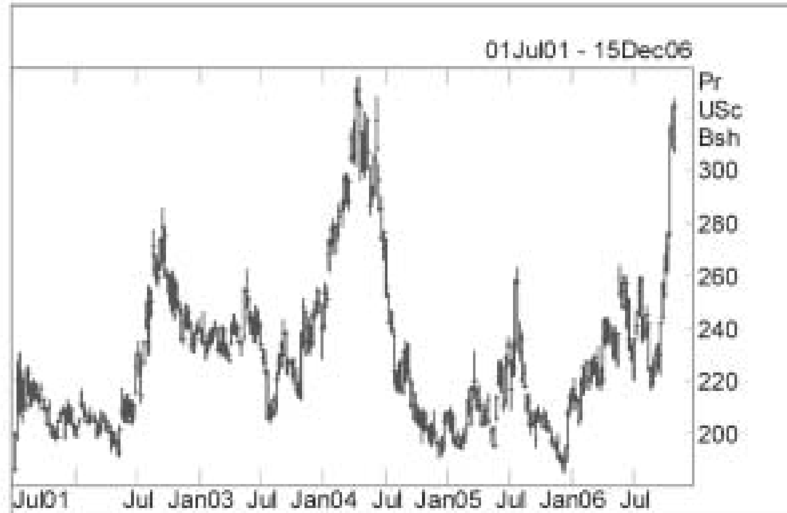
Chart 1 – Weekly nearest contract corn



Courtesy Reuters

COTTON

Overestimating demand?

Cotton prices have been declining throughout this past summer and into early fall. The reasons for the weakness were not entirely obvious, particularly since the US, by far the world's largest exporter, was slated to have a sub-par crop. Furthermore, global demand grew by 6% in the 2005-06 marketing year and is expected to grow by an additional 4% this season. Global inventories are on track to decline for a second consecutive year.

The US cotton crop was planted on 15.28 million acres, 1 million acres more than in 2005-06. Growing conditions, however, were relatively poor. As of the most recent crop progress report of the season, the good-to-excellent portion of the crop was only 41%, in stark contrast to last year at this time, when the top category represented 61% of the crop. The planted-to-harvested ratio is expected to fall to 84% from last year's 97%. As a result, average yields are estimated to fall 7%, to 774 pounds per acre. Even after the upward revision contained in the USDA's October estimate, output was estimated at 20.66 million bales, down over 3 million bales from the record production we saw in 2005-06.

A series of revisions contained in the October USDA supply/demand situation report, however, changed the global balance sheet considerably and helped put tumbling prices in perspective. First, there was a 2.5-million-bale upwards revision to 2005-06 global carryover stocks. Then, the estimates for US and Chinese output were increased by 300,000 and 1 million bales respectively. Consumption was lowered by 1.25 million bales. Along with some other minor changes, the estimate for 2006-07 global ending stocks jumped by 5.5 million bales, to 52.26 million bales, from the September estimate. This means that stocks are now forecast at 43% of consumption, a dramatic leap from the September estimate of 38% of consumption.

Although inventories are still technically in decline – they peaked at 50% of consumption 2004-05 and slipped to 47% in 2005-06 – we get a much clearer picture of why prices have been so weak. The 38% estimate was stale, and the ticker – as usual – knew the real story.

The USDA has cranked up the estimate for Chinese consumption, and even after a 1-million-tonne downward revision this month, we are looking at domestic usage of 50 million bales, up from 45 million bales in 2005-06. Some analysts are skeptical about such a large increase. Imports are forecast to fall by 800,000 bales, partly because of the record 29-million-bale crop, which is up from 26.2 million bales last year. But there is another significant issue that could allow Chinese imports to fall even further and affect world trade: The spread between cheaper imports and more expensive domestic cotton has narrowed to almost zero.

The USDA has accounted for this to some degree, by lowering its estimate for 2006-07 US exports to 16 million bales, from 18 million bales in 2005-06. Still, the pace of export commitments is lagging even the reduced estimate. As of the most recent export report, total cotton sales this marketing year, which began on August 1, stand at 3.94 million bales, compared with 6.94 million bales at this time last year.

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The short-lived short-covering rally we saw over the past couple of weeks was probably partly due to the downward revisions to Pakistani output. A government official confirmed that there was substantial damage from heavy rains and subsequent flooding, as well as the outbreak of virus in some regions. Production estimates were slashed by 10%, which amounts to about 1 million North American-size bales.

We have a fairly good idea of what new supply will be, now that most crops are harvested. The key issue will be demand. If US exports – the harbinger of global consumption – do not narrow the gap with last year's pace, the market will drift lower. During the past few years, when US exports shot up, the optimistic USDA forecasts turned out to be accurate. In mid-season we would see huge weekly sales tallies that quickly silenced the skeptics. But we're in a different environment because China has grown such a large crop, and as illustrated above, the price advantage of importing has disappeared. It will be a tall order to meet the USDA estimate.

We recommend trading cotton from the short side, but remind traders that it is a thinly traded market.

[November 2, 2006]

Chart 2 – December cotton

Courtesy Reuters

SUGAR

The bull is history

"We wait patiently for the market to stop falling, but we retain a long-term bullish bias." That was the conclusion of the most recent *Focus on Futures* article on sugar, published on August 30. Well, with a month-long consolidation at hand, the market seems to have stopped falling. We have nevertheless most certainly changed our minds regarding the part about the long-term bullish bias.

Prices collapsed earlier this year, mainly because major producing countries responded to higher prices by growing much larger crops. In addition, the Brazilian government engineered a cutback in ethanol usage to curb rampant demand growth and the resulting skyrocketing prices. But the degree to which output has grown has surprised us, and we do not believe that the market has fully accounted for rapidly rising supplies.

The 2006-07 Brazilian crop is estimated to reach a record 30.86 million tonnes, up a whopping 15% from 2005-06 output of 27.1 million tonnes. One of the primary reasons for the bull market that drove prices to nearly 20¢ per pound back in February was the rapid acceleration of the ethanol market in Brazil, in both domestic demand and in the creation of an infrastructure for efficient exports. The sugar market was sharing the cane crop with the ethanol market. There were concerns that the world's largest producer and exporter would have difficulty meeting its sugar export commitments, thus tightening the pool of sugar available for world trade.

On March 1 the government dropped the 25% required minimum ratio of ethanol in vehicles to 20%. Predictions that the allocation of the cane crop would soon move to an

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ethanol/sugar ratio of 55%/45% were unfounded. The ratio continues to hover around 50%/50%, which leaves ample supplies available for the sugar export sector and allows the ethanol market to grow at whatever pace the energy market will dictate.

Over the past couple of months there has been talk that since the government was satisfied with its success in lowering both consumption and prices of ethanol in addition to feeling pressure from the ethanol industry, it was prepared to push the minimum ethanol/petroleum mix back up. On October 31 an increase to 23% was announced, to take effect on November 20. The market greeted the news with a yawn, and prices merely continued to consolidate.

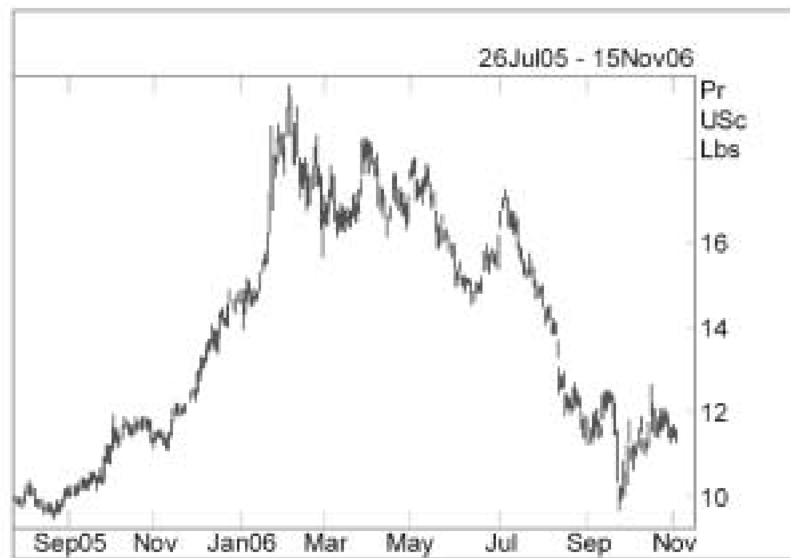
Even more dramatic than the supply increase in Brazil is the jump in Indian output. In the early stages of the 2006-07 growing season, the crop was estimated at a record 22 million tonnes, up from 20 million tonnes in 2005-06. The US attaché estimates production at 25 million tonnes, but some private forecasters, such as F.O. Licht, put the crop as high as 27 million tonnes. And the Indians will not necessarily be looking to put all surpluses towards rebuilding their once huge – but now dwindling – stockpile. This past season India exported 1.5 million tonnes of sugar, and if the government removes its restrictive export policies, exports are expected to grow to 3 million tonnes.

The most recent estimate of the global balance sheet released by F.O. Licht on October 31 puts it all together and shows how the market has swung from bull to bear market. Global production is expected to grow 5.85% from the previous season, to 160 million tonnes, while consumption should rise only 1.98%, to 148.3 million tonnes. This represents a massive turnaround from a deficit in 2004-05 to a small surplus in 2005-06, to this season's forecasted 12-million-tonne surplus. Stocks as a percentage of consumption would jump to 48.99% of usage, compared with 44.14% at the end of 2005-06.

CFTC data show that commodity funds still own a stale net long position of 35,000 contracts, and the holders of those positions cannot possibly be very happy with the market making fresh recent lows.

The market has already fallen substantially, but we can think of no reason why this market will not return to its pre-bull-market lows. We recommend being short, using the 13¢-per-pound level as a stop. *[November 3, 2006]*

Chart 3 – March sugar



Courtesy Reuters

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