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Have huge corn crops alleviated global tightness?

The 2004-05 US corn harvest is in full swing, and according to the October USDA supply/demand situation report, the crop will be a dandy. The estimate for the crop was raised by 16.6 million tonnes, to 294.99 million tonnes, a significant 6% increase over the September forecast, which was already in record territory. Last season's output was 256.9 million tonnes. While the street was expecting an increase, analysts were off the mark by a wide margin. The average guesstimate was 284.7 million tonnes.

US farmers enjoyed a combination of ideal planting, growing, and – with any luck – harvest weather, which will result in record yields. While corn acreage was 3% larger than 2003-04, bountiful yields are responsible for the huge jump in output. The forecast for yields was raised by 9 bushels per acre (bpa) from the September estimate, to 158.4 bpa, compared with 142.2 bpa in 2003-04 and 129.3 bpa in 2002-03.

At the global level, there were several downward revisions to output, but they were more than offset by increases in China and European producers outside the EU 25.

Overall, the estimate for global output was raised by 19.3 million tonnes, to 683.74 million tonnes, from the September estimate, while the estimate for global demand was increased by only 7.25 million tonnes, to 677.76 million tonnes. This compares with 2003-04 output of 618.86 million tonnes and consumption of 646.18 million tonnes. As a result, the forecast for 2004-05 ending stocks jumped to 100.68 million tonnes, or 14.9% of consumption, compared with 13.1% in the September report.

This wrap-up of the October USDA report paints an increasingly bearish picture and puts the six-month price slide in proper perspective.

True, global production has exploded, as illustrated, and we're looking at the first production/consumption surplus since 1999-00. At the same time, we should bear in mind that the explosive growth in global output was a response to a similarly explosive growth in demand. Although the estimate for 2004-05 ending stocks jumped from last month, in the grand scheme of things, there's been little improvement over 2003-04, when final ending stocks were 14.8% of consumption, compared with the October estimate for 2004-05 of 14.9%. Global inventories still stand at 30-year lows.

The USDA estimates US exports for 2004-05 at 52.71 million tonnes, 4.45 million tonnes above 2003-04. The way things are going, this will be a formidable challenge to overcome. As of this past week's sales report, commitments stand at 12.7 million tonnes (24% of annual export estimate), down from 13.9 million tonnes (28.8% of final annual exports) at the same time last year.

Actually, last week's report presented a glimmer of hope, with new sales of 1.48 million tonnes, significantly above the average of the previous 4 weeks of 1.017 million tonnes. In addition, a large sale to Japan of close to 300,000 tonnes was reported after the release of the weekly figures, which sets up the following report for a decent tally as well.

We are motivated to take a stab at the long side partly because the contrarian in us sees sentiment numbers running at 52-week lows and because the market's reaction to the

Inside

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

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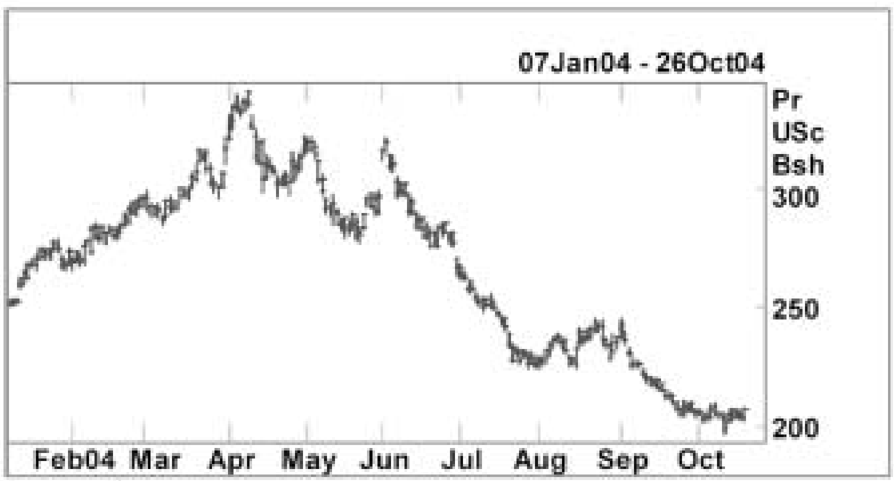
monthly USDA report was rather constructive. The market made new contract lows on the day of the report, but has been inching higher ever since – a sell-the-rumor-buy-the-news scenario in the making.

The increase in corn ethanol usage does not receive much attention, but is an important long-term bullish factor. Demand for ethanol should continue to grow as its consumption becomes more commercially viable, particularly with petroleum products being priced off $50-per-barrel crude oil. According to the USDA, 34.8 million tonnes of the US corn will be converted into ethanol in 2004-05. This represents 12.6% of total consumption and compares with 11.7% in 2003-04 and 10.5% in 2002-03.

Although the bullish case is not very clear at this time, we are recommending a long position at these levels. Market participants have spent a good deal of energy focusing on the mammoth US crop, but have perhaps neglected the fact that despite fantastic increases in output, we have not been able to rebuild historically low world inventories. Any unexpected uptick in demand will send carryover stocks back to levels that drove prices to $3.50 per bushel last spring. With prices having touched two-year lows, we are vulnerable to any bullish surprises. *[Oct. 19, 2004]*

STRATEGY: *Maintain long December, as per Flash Update of October 14. Raise stops to 196, close only.*

Chart 1 – December corn



Courtesy Reuters

SOYBEANS

Will low prices reignite demand?

When soybean prices were trading above $10 per bushel back in April, it was difficult to construct a coherent bearish argument of any sort. The case simply did not exist. The world's largest grower, the US, had all but run out of beans. Brazil, the second biggest producer was harvesting and marketing a record crop, but weather problems would eventually trim the crop by close to 9 million tonnes, or 14%, from original estimates.

The USDA published its first significant cut to the Brazilian 2003-04 crop estimate as early as May. Asian buyers couldn't get enough of the stuff. The outlook was bullish as far as anyone could see. Then Chinese banks began to tighten the credit markets, and crushers, unable to handle the pressure of soaring bean prices *and* higher financing costs, began to turn back Brazilian shipments. Imports eventually ground to a halt and prices fell by more than 50% from their peak.

At present, we have an inverse – but similar – situation. The supply/demand fundamentals are as bearish as they've been in years and even more so with the revisions contained in this month's USDA monthly supply/demand situation report. Ideal weather conditions will allow US farmers to harvest a record crop of 84.46 million tonnes, a significant, 7.4-million-tonne upward revision from the September estimate. Although the new figure was not a shock to the street, it was 2 million tonnes above the average guesstimate and enough for a 26¢-per-bushel slide to new lows on the day the USDA report was released.

As a result of this revision to the US crop, the global inventory picture has been altered considerably. The estimate for 2004-05 ending stocks rose to 59.25 million tonnes, or 28.5% of consumption, up from the September estimate of 51.54 million tonnes, or 24.7% of consumption. This compares with 2003-04 ending stocks of 38.59 million tonnes, or 19.9% of consumption, and 40.67 million tonnes in 2002-03, or 21.4% of consumption.

Although there is little, if anything, to be found in the fundamentals to indicate that the steep fall in prices has ended, trend-ending developments are rarely obvious. At the top of the market, tight credit conditions appeared as an unexpected development. But high prices were equally responsible for creating the peak in the market.

Now that beans are trading at two-year lows, we find ourselves at the other end of the spectrum. Will demand remain as sluggish at these prices as it was when beans were trading at significantly higher prices? Probably not.

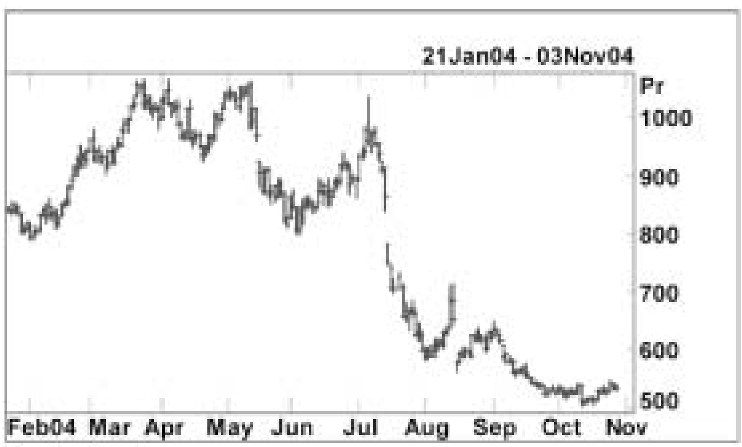
Unlike corn and wheat, in which its import needs are marginal relative to its total domestic consumption, China must buy more than half of its bean requirements abroad. The USDA estimates domestic needs at 37.7 million tonnes, against a record crop of only 17.5 million tonnes. Of course, it's a question of just how much it will buy, but export commitment data indicate that Chinese purchasing patterns have been quite strong this season. So far, the Chinese have committed to buy 4.04 million tonnes of soybeans for the 2004-05 marketing year, compared with 8.23 million tonnes it imported for all of 2003-04.

Low prices can also manifest themselves on the supply side. The USDA lowered its estimate for the 2004-05 Brazilian crop to 64.5 million tonnes, from an earlier 66-million-tonne estimate. Other estimates come from Brazilian analyst Safras and *Oil World*, with forecasts of 63.2 and 60 million tonnes respectively. Crops in South America are just going in the ground, which leaves ample time for farmers to make decisions regarding both how much to plant and how much to spend on fertilizers whose prices have been rising. It is therefore difficult to estimate the size of the Brazilian crop until the crop is completely planted.

We are *becoming* bullish. The explosive demand that resulted from the rapidly growing hog and chicken population in Asia has not disappeared. The price is right for buyers to return to the market. There is a distinct possibility – as illustrated – that two or three months down the road, the burdensome stocks-to-consumption ratio will not look quite as burdensome as it does at present. *[Oct. 27, 2004]*

STRATEGY: *Remain sidelined, but stay tuned.*

Chart 2 – Nearest contract soybeans



Courtesy Reuters

COCOA

Grinding activity not reflecting strong butter demand, yet

Over the past two months, cocoa prices have been drifting in a narrow trading range. Aside from a brief poke above the range in mid-September, we've been trading between $1,400 and $1,500 per tonne. The lackluster activity in the cocoa pits, however, is not necessarily indicative of the fundamental developments that are brewing, which could set the tone for a breakout or breakdown. Most of these developments should have been negative for prices, but the market seems to be holding rather well.

Earlier this month we took a long position in cocoa, primarily on the belief that soaring demand for butter would ultimately show up in quarterly grinding statistics. They did not and we tightened our stop to reflect our concern. Our stop was triggered promptly at the low tick of the post-grind move, but the market stabilized and headed back to the top of the range. A nifty bit of trading.

The US grind rose 2.02% in the third quarter, in line with expectations. The European grind was up 1.78% and was quite a disappointment. The German grind, which is released several days earlier, was up 10.6% for the quarter. Traders believed that the German results might be a reflection of European activity as a whole.

On October 11, unions representing Ivorian farmers announced that they would stage a strike, which would include withholding beans and blockading ports to protest low farm-gate prices set by the government. The unions were looking for 500 cfa per kg and were incensed when the level was set at 390 cfa per kg. We believed that prices were being supported by the strike. But when the unions announced late last week that the strike would be lifted while a new round of negotiations between the parties took place, prices remained steady. The strike action could resume if union representatives are not satisfied with the outcome of talks with the government.

Once the strike ends, as strikes eventually do, participants will turn their attention to the 2004-05 Ivorian and other West African crops. There has not been too much in the way of forecasts to date, but there isn't any reason to assume that these countries will not have normal-sized crops.

Several years ago, the Ghanaian government announced that it was promoting programs that would increase cocoa production dramatically. The 1-million-tonne number was thrown around. At the time, those plans seemed rather futuristic. But Ghanaian output has increased from the 350,000-500,000 tonne range in recent years, to 736,000 in 2003-04 and to an initial forecast of 700,000 tonnes for 2004-05. A good deal of Ghanaian port arrivals – perhaps 150,000 tonnes – are thought to be smuggled Ivorian beans, which means that we're probably more in the 600,000 tonne area for Ghana. But then Ivorian output would actually be about 1.5 million tonnes, not 1.4 million tonnes. Ghana's long-term plan has made some inroads, and either way, combined West African output is on the rise.

In recent articles on cocoa we pointed out that the fear premium that was built into the market to account for the risk of disruption of Ivorian supplies because of the fragile political environment was probably no longer warranted. After two years of optimum-sized crops, which were produced during fierce violence, it seemed that the farm, transport, and port infrastructures were strong enough to withstand the unrest. On October 27, E.D.&F. Man issued a report that in essence said that this is not the case and that the tensions could escalate to broaden the conflict and threaten supplies. While this is not a good enough reason to be long cocoa, perhaps we were wrong in assessing the potential risks.

The supply side is not our issue. The constructive market action, however, in the face of mostly bearish news, is a helpful, motivating factor. We continue to focus on the implications of soaring butter ratios.

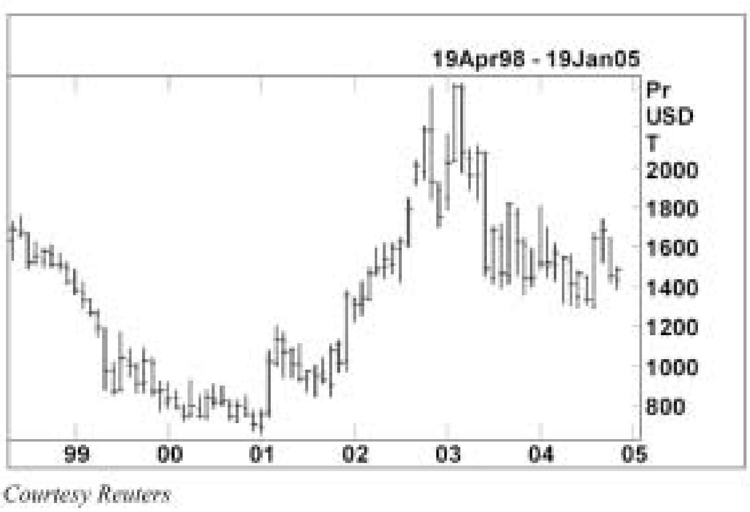
European ratios have jumped to an all-time high of 3.5 times London, up from 3.1 a few weeks ago, and exceeding the 1990 high of 3.2. Asian ratios, while not quite as high, continue to rise as well and are quoted at about 2.9. Now, admittedly, we are not clear about the relationship between bean and butter prices. In fact, the big rise in butter ratios between 1988 and 1990 was at one point accompanied by a rally from $950 to $1,500 per tonne, but the major trend was down, and bean prices did not bottom in earnest until 1993.

In terms of precedent, then, we cannot say that strong bean purchases and subsequent increase in grindings by processors will necessarily follow to deplete world inventories. On the other hand, we do know that butter demand is high and stocks are low. There is at the very least a logical argument to say that at some point processors will have to ramp up their bean purchases.

The bullish case hangs on this one aspect. The bearish case has many more components, as illustrated. The market would need to break below $1,300 to vindicate the bearish arguments, which it has failed to do despite repeated attempts over the past 17 months (Chart 3). We have re-entered the long side. *[Oct. 29, 2004]*

STRATEGY: *Remain long March cocoa, as per Flash Update of October 26. Maintain initial stops at 1390, close only.*

Chart 3 – Nearest contract cocoa



Courtesy Reuters

WHEAT

A dramatic recovery in the global crop

Global wheat output has ended a multi-year decline and in a big way. The USDA raised its 2004-05 production forecast from its September estimate by 5.23 million tonnes, to 615.84 million tonnes. This compares with 2003-04 output of 551.57 million tonnes and 2002-03 output of 566.93 million tonnes. The large gains are expected primarily in importing countries, with the exception of the EU, which is bouncing back from last year's intolerable heat waves that slashed output by some 15% from its typical output. The crops of major exporters are not responsible for the surge in production. The US crop is actually expected to decline by 4.93 million tonnes, or 7.7%, while the size of the Australian, Argentinean, and Canadian harvest should be similar to 2003-04.

Despite the explosive growth in output, in the grand scheme of things, we have not made any great strides in restocking global inventories. Demand is expected to grow as well, albeit a slower rate than output, to a record 605.31 million tonnes, 17.33 million tonnes above last year. While the global production/consumption balance will see its first surplus since 1999-00, the resulting 10.53-million-tonne increase in ending stocks over 2003-04 will make barely a dent in the overall picture. Ending stocks for 2004-05 are estimated at 141.51 million tonnes, or 23.4% of consumption. This will be higher than 2003-04 ending stocks of 130.98 million tonnes, or 22.3% of consumption, but still well below 2002-03 ending stocks of 167.39 million tonnes, or 27.8% of consumption.

The market is well supplied at the moment. Prices are low relative to where we've been over the past two years, but there isn't any compelling reason to be found in the statistics to be fishing for a bottom. Still, similar to arguments we made in articles written earlier this month for corn and soybeans, we should not ignore the fact the low prices can create or restart bull markets. Market participants are focusing on the fact that crops have exceeded expectations, and have not paid as much attention to the possibility that while demand growth has lagged to some degree, consumption patterns may behave differently at lower price levels.

For example, the USDA raised its estimate for 2004-05 US wheat exports this month by 680,000 tonnes, to 26.54 million tonnes. This revision is still significantly below final 2003-04 exports of 31.56 million tonnes and reflects pessimism about the general outlook for demand. The USDA had to raise its estimate because current data indicate that demand for US wheat is definitely better than was anticipated, and it is likely to raise the estimate again in its November supply/demand situation report.

Export commitment data show that US exporters have sold 16.2 million tonnes this season, compared with 15.7 million tonnes at this time last year. Shipments are at about the same level. Given the smaller annual estimate for 2004-05, we've completed a greater percentage of business at a much earlier date. We've put some decent numbers on the board lately, and it is improbable that we're going to slow down to a pace that would facilitate only 26.54 million tonnes of exports. Average commitments for the past week have been 555,000 tonnes, and we would have to fall into a pattern of roughly just over 300,000 tonnes per week to justify the USDA estimate.

China is expected to have a fairly good crop of 90 million tonnes, 3.5 million tonnes above last year's. Over the past year we talked about China increasing its buying of foreign wheat, and that seems to be developing. Last year the Chinese imported 3.75 million tonnes from foreigners, 1.1 million tonnes of which came from the US. The USDA estimates that China will buy 8 million tonnes this season. Purchases from the US to date stand at 1.96 million tonnes, more than it bought all of last year. While that may seem quite constructive this early in the season, we should point out that most of those sales took place some time ago, during the 2003-04 marketing year, and there has been very little Chinese activity since.

We're not rushing out to buy wheat, but we know what to look for. Any uptick in demand will draw us back to the long side. *[Nov. 1, 2004]*

STRATEGY: *Remain sidelined.*

HOTLINE UPDATE

***Flash Update* – Tuesday, October 5, 2004:**
Good morning for Tuesday, October 5, 11 am. This is a Flash Update. We have sold short December mini Nasdaq at 1464.75, placing our initial stop at 1515, close only.

***Flash Update* – Wednesday, October 6, 2004:**
Good afternoon for Wednesday, October 6, 4:30 pm. This is a Flash Update. We have covered our short December mini Nasdaq position at 1479.

Friday, October 8, 2004:
Good afternoon for Friday, October 8, 4:20 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

On October 5 we sold short December mini Nasdaq at 1464.75. On October 6 we covered our short December mini Nasdaq position at 1479. We currently have no positions.

***Flash Update* – Tuesday, October 12, 2004:**
Good morning for Tuesday, October 12, 9.05 am. This is a Flash Update. We have purchased December cocoa at 1457, placing our initial stop at 1375.

***Flash Update* – Thursday, October 14, 2004:**
Good morning for Thursday, October 14, 11:05 am. This is a Flash Update. We have purchased December corn at 203.75, placing our initial stop at 193.75, close only.

Friday, October 15, 2004:
Good afternoon for Friday, October 15, 4:00 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

On October 12 we purchased December cocoa at 1457. On October 14 we purchased December corn at 203.75.

We are currently long December cocoa at 1457, with our initial stop at 1375; and long December corn at 203.75, with our initial stop at 193.75. All stops are close only.

***Flash Update* – Wednesday, October 20, 2004:**
Good afternoon for Wednesday, October 20, 12:05 pm. This is a Flash Update. We have liquidated our long December cocoa position at 1425.

Flash Update -- Thursday, October 21, 2004:
Good afternoon for Thursday, October 21, 12:20 pm. This is a Flash Update. We have purchased December copper at 130.15, placing our initial stop at 126.90, close only.

Friday, October 22, 2004
Good afternoon for Friday, October 22, 4:40 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

On October 20 we liquidated our long December cocoa position at 1425. On October 21 we purchased December copper at 130.15.

We are currently long December corn at 203.75, with our stop at 193.75; and long December copper at 130.15, with our initial stop at 126.90. All stops are close only.

***Flash Update* – Tuesday October 26, 2004:**
Good morning for Tuesday, October 26, 11:55 am. This is a Flash Update. We have purchased March cocoa at 1472, placing our initial stop at 1390, close only.

***Flash Update* – Thursday, October 28, 2004:**
Good morning for Thursday, October 28, 10:25 am. This is a Flash Update. We have sold short March sugar at 8.72, placing our initial stop at 9.08, close only.

***Flash Update* – Thursday, October 28, 2004:**
Good afternoon for Thursday, October 28, 1:20 pm. This is a Flash Update. We have liquidated our long December copper position at 125.15. We repeat our Flash Update of earlier today where we sold short March sugar at 8.72, placing our initial stop at 9.08, close only.

Friday, October 29 2004
Good afternoon for Friday, October 29, 4:10 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

On October 26 we purchased March cocoa at 1472. On October 28 we sold short March sugar at 8.72, and liquidated our long December copper position at 125.15.

We are currently long December corn at 203.75, with our stop at 196; long March cocoa at 1472, with our initial stop at 1390; and short March sugar at 8.72, with our initial stop at 9.08. All stops are close only.

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