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Have we solved the corn problem?

The fortunes of the US corn market over this past summer shifted several times. A very wet spring season delayed planting. By mid-May, only 75% of the crop was in the ground compared with the 5-year average of about 90%. When the crop finally did get in the ground, flooding in the early growing stages threatened significant acreage losses. Still, the crop seemed to be muddling through. The August 12 USDA crop estimate came in at 12.288 billion bushels, close to 600 million bushels higher than the July estimate, and 300 million bushels above the average street guesstimate.

From early-July through mid-August, corn prices had already fallen by close to $3 per bushel, and the August estimate was but a confirmation that we were heading back to pre-bull market price levels. Then – in classic sell-the-rumor-buy-the-news fashion – corn prices opened at the low tick on the morning of the report's release only to embark on a $1-per-bushel rally over the next couple of weeks.

The next twist was the drubbing taken by commodity markets in the last two weeks of August, which left corn prices little chance of standing up to the tidal wave of selling. Unlike many other agricultural commodities, though, corn prices held their early-August lows.

Analysts were in the zone with their outlook for the September crop report. The estimate came in at 12.072 billion bushels, but at 80 million bushels below the average guesstimate, the report was deemed bullish enough to inspire a 30¢-limit-move in most new-crop months.

While the supply side got a bullish boost from the September crop report, traders have been focusing on the potential for a weakening demand side for commodities in general. Indeed, there are arguments to be made that consumption is suffering in the corn market.

As the new marketing year begins, we've seen the US export market turn rather sluggish. Combined old- and new-crop commitments have averaged just 625,000 tonnes over the past four weeks. While overall global demand is expected to grow, the USDA has built in lower foreign demand for US corn, with estimated annual sales of 50.8 million tonnes, down from 2007-08 exports of 60 million tonnes. But even so, weekly sales need to be much closer to 1 million tonnes to reach even the reduced forecast. Part of the challenge will be competition from FSU and Eastern European feed wheat, which will make up a larger percentage of the total wheat crop than typical because of excessive moisture, which compromises quality and renders wheat unusable for food-grade milling.

In addition, many have been arguing that ethanol usage estimates have been overstated, and with oil prices on the slide, it seems that the alternative fuel case is not as strong as it was when crude prices were flying. Curiously, back in the August crop report, the USDA actually increased its estimate for US ethanol usage by 150 million bushels. This estimate is based on the fact that US distillers have increased capacity dramatically over the past year – by 57%, to 10.7 billion gallons. Now we'll have to see if it gets used.

Looking to the future, the prospects for the 2009-10 crop are mixed. On the one hand, natural gas prices have fallen steeply, which will bring fertilizer costs back into line – if prices stay down long enough to produce fertilizer at these lower costs before planting commences in the spring.

Earlier this past summer, the USDA had been toying with releasing land without penalty from the 35-million-

Inside

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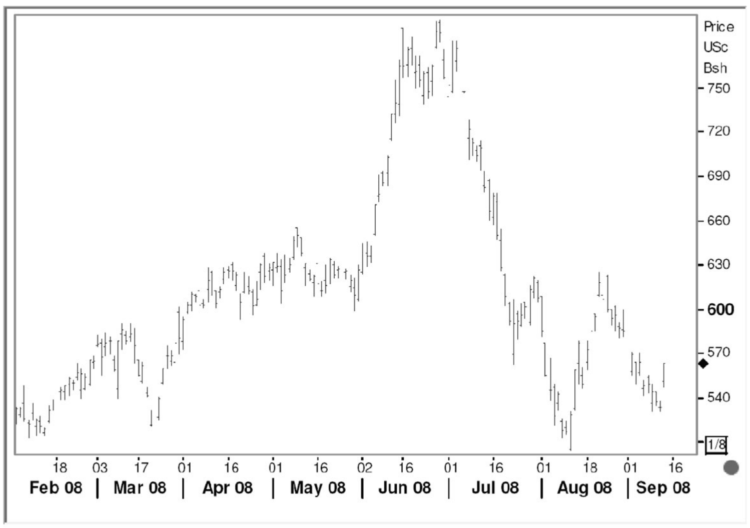
acre Conservation Reserve Program. In July, when crops seemed to be humming along comfortably, it announced that it would not release any acres in time for the 2009-10 crop. Now, with the crop maturing at a pace that could make it susceptible to early frost, the USDA has again floated the idea of releasing acres.

Overall, there have clearly been bearish developments on the demand side, and there is no telling whether the usage estimates are accurate or whether a worldwide economic slowdown will cut further into food and industrial consumption. However, if the forecasts for the 2008-09 global balance sheet are anywhere near correct, we have not scratched the surface of solving the global tightness. With the September revisions, global ending stocks as a percentage of consumption will be 13.9%, down from 15.9% in 2007-08 and 14.9% in 2006-07.

The market has established support at the $5-per-bushel level. Although it is difficult to get very bullish with weak demand on the horizon, it is also quite clear that prices have not been high enough for long enough to bring global inventories back to comfortable levels. We advise maintaining long positions. *[September 18, 2008]*

Chart 1 – December corn



Source: Reuters

WHEAT

A record global crop

Technically speaking, wheat sports what can be described as one of the most bearish-looking charts among agricultural commodities (Chart 2). It has violated long-held support levels and is trading back at mid-2007 prices. For good reason. In the US, winter wheat crops have long been harvested and the spring wheat harvest is just about complete. Where corn and soybeans still have to struggle with late-maturing crops vulnerable to early frost, the wheat crop is made. The same situation exists for the other major Northern Hemisphere producer/exporters: Canada, the FSU, and the EU. To boot, the USDA's September crop report raised production estimates for the FSU and the EU by 4 million tonnes each.

It seems tempting to declare the bull market over and be satisfied that the tightness that drove wheat prices into the stratosphere has ended. After all, the estimates for global wheat output are nestling in at the high end of forecasts that we've seen over the past few months. At 676 million tonnes – a record by far – we're 66 million tonnes, or more than 10%, above 2007-08 output.

But is it enough?

The USDA estimate for 2008-09 global consumption is 655 million tonnes, up from 619 million tonnes in 2007-08. This marks only the third time since the 1997-98 season that the global wheat market will show a production/consumption surplus of any significance.

To actually rebuild global inventories, this burst of production would have to be sustained and repeated in 2009-10, because global demand will continue to grow or stagnate. Either way, if we do not see continued growth in world acreage and crops, we will be no further ahead. From the beginning of this decade until the bull market began in earnest during the 2006-07 season, global ending stocks as a percentage of consumption averaged 28% of consumption. In 2006-07 and 2007-08, inventories nosedived to 20.6% and 19.1%, respectively. According to the September USDA estimate, 2008-09 ending stocks will recover to only 21.36% of consumption.

While the large crops seem to have calmed the markets, the 676-million-tonne global production figure might prove to be somewhat misleading. There are two issues we think bear monitoring.

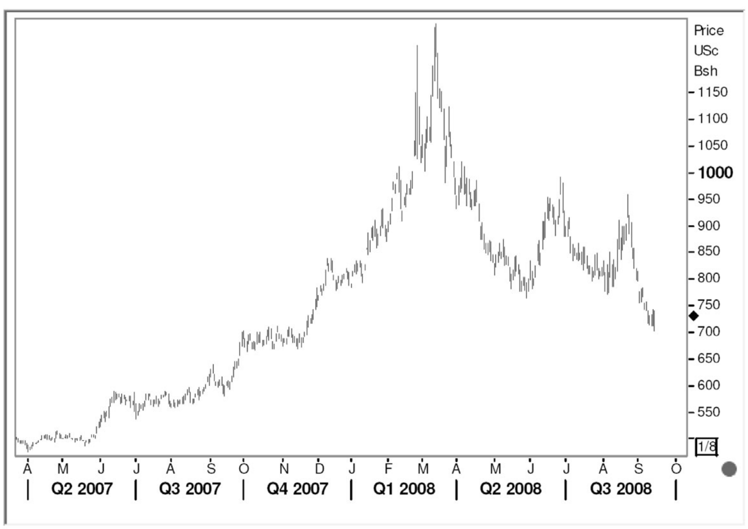
First, it has been known for months that FSU crops received excessive moisture, and a much-larger-than-typical percentage of crops in the region will be sold only as cheaper feed wheat. Last week, for example, it was reported that both Egypt and Tunisia rejected cargos of Ukrainian wheat because it was not of food quality. The wheat we trade in Chicago and Kansas City is priced as food quality wheat, and the mammoth crops of animal-feed wheat are largely irrelevant.

The USDA is forecasting a sharp downturn for US exports in 2008-09 – to 27.22 million tonnes, down from 34.40 million. Certainly, commitment activity in the first two months of the new marketing year supports the USDA outlook, with sales 20% behind last year's pace. If our hunch that bread-quality wheat is in short supply is correct, there is a strong possibility that the USDA estimate is too low.

The other problem with assuming that supplies of exportable wheat are plentiful is Australia. The crop down under has been struggling with drought since the start of the planting season. Precipitation has been inconsistent. The USDA took what we believe is the rather unusual action of lowering its estimate for the Australian crop this early, by 3 million tonnes from its August estimate. If that is the extent of it, then it's in the market and should not matter. However, Australia is a key player in world trade, and if its crop is in fact in worse shape than the reduced September estimate, the pool of available bread-quality wheat shrinks further.

Any indication that US export sales are picking up or that the Australian crop is slipping below 20 million tonnes would warrant a buy recommendation. *[September 18, 2008]*

Chart 2 – December wheat



Source: Reuters

COCOA

Sloppy supply side

The cocoa market has been responding to anything and everything, except that which pertains to the cocoa market. Caught up in the massive commodity liquidation, prices have fallen by $800 per tonne, or 25%, since early July. Chart 3 illustrates the particularly large, often gut-wrenching (when you're on the wrong side only), inter-day swings that this market is famous for.

For many commodities, the bull markets that saw prices double, triple, or in some cases, quadruple facilitated some simple economics in which producers took advantage of high prices by producing more and/or increasing investment in inputs to enhance production. This did not happen in the cocoa market. While cocoa is a unique agricultural product in that it takes years from planting to actual production, the market is plagued with problems that have kept output stagnant.

In the Ivory Coast, as the 2007-08 mid-crop draws to a close, total arrivals stand at 1.33 million tonnes, compared with 1.22 million tonnes at this time last year. Strife among rebels in the north and government forces in the south has long threatened to curb production and exports, but the fears never materialized. But climatic conditions, the spread of disease, and good old fashioned corruption have kept the Ivory Coast from increasing output materially.

While the 2007-08 crop may be larger than the previous year's, quality is poor. Wet weather has hampered the necessary drying process. Black pod disease seems to be spreading, compromising a larger portion of the crop each year. What Mother Nature has not accomplished, corruption has. The heavy taxes that the government has been levying on the industry were supposed to go back into fertilizers and other inputs, but the money vanished.

Furthermore, the new main crop, which will be harvested starting in October, is slated to be 6% to 8% smaller than this past year's crop because of black pod disease.

The situation in West African neighbor Ghana is similar. Arrivals for 2007-08 reached 680,000 tonnes, just shy of forecasts of 700,000 tonnes, but still sharply above 2006-07 output of 615,000 tonnes. The government has been talking for years about investing in expanding its crop to 1 million tonnes. But early estimates for the crop are in the 650,000-tonne area.

The biggest problem on the supply side is one that doesn't capture many headlines. Indonesian output is falling precipitously. This year's crop is expected to reach 480,000 tonnes, down from 530,000 tonnes in 2006-07 and 600,000 tonnes in 2005-06. Pod borer disease covers as much as 60% of plantations in Sulawesi Province, the main growing region. There is a serious move to replace cocoa plantations with far more profitable crops such as corn.

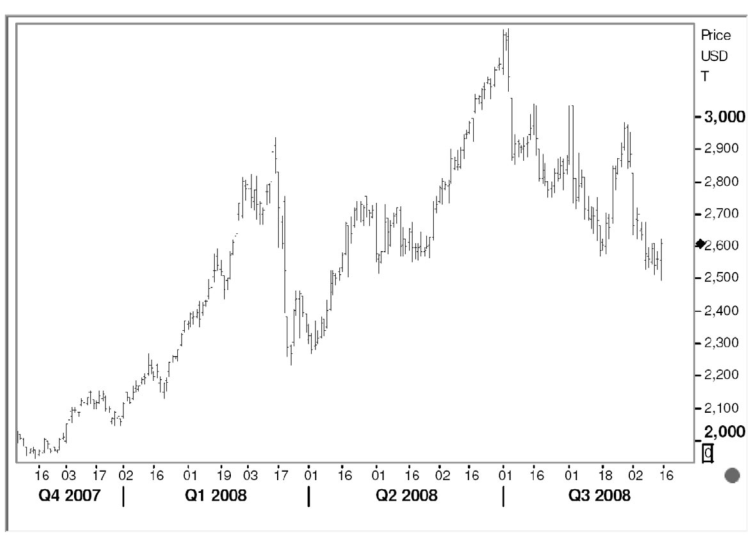
The recent disappointing close of the 2007-08 West African crops prompted the International Cocoa Organization (ICCO) and other analysts to increase their global deficit forecasts by about 50,000 tonnes to roughly 100,000 tonnes. The stocks-to-consumption ratio will fall to about 40% from 43% in 2006-07. Although everyone is in agreement that output should fall in 2008-09, analysts are looking for a balanced market, because they assume that demand will flatline on account of a global economic slowdown.

On the other hand, some estimates call for continued consumption growth at a rate of about 3% in 2008-09, down from an average of about 4% over the past 5 years.

In conclusion, this market remains as vulnerable as it has ever been. With Indonesian output in what seems to be permanent decline, the burden on West African crops has increased. And as illustrated, the crops are at best steady, and possibly in decline as well. If demand does continue to grow, and we have not seen any evidence to the contrary to date, the possibility of another deficit looms large.

We advise maintaining manageable long positions.
[September 18, 2008]

Chart 3 – December cocoa



Source: Reuters

COTTON

Weak demand, yes, but even weaker supplies

A perception among market participants that consumption is about to plummet is the primary issue guiding the cotton market. Output has been in decline and is likely to continue that trend, because it is more profitable to cultivate other crops. Were fear of declining demand not so prevalent, things would look a little different.

After opening the new marketing year in August with exports moving at a healthy clip, the last couple of weeks saw new sales stall, particularly two weeks ago, when commitments were a next-to-nothing 25,000 bales (weekly sales need to average about 275,000 bales to meet the USDA forecast). In the September supply/demand situation report, the USDA had already trimmed its estimate for 2008-09 by 500,000 bales, to 14.5 million bales.

We're not in a position to predict what effect a global economic slowdown will have on cotton usage over the coming months. There are, however, two points that illustrate how the relevance of the economy might be limited.

First, cotton is frequently referred to as an industrial commodity, and the argument always follows that consumption patterns will follow economic activity. Chart 4 shows that for the most part, cotton usage has been in a steady uptrend over the past two decades, even though we've lived through some fairly turbulent economies.

Second, even when demand was weak, prices may have fallen only because of strong increases in production. For example, the 2004 bear market, which saw prices drop from 85¢ to 40¢ per pound, occurred in an environment in which global production rose from 95 million bales in 2003-04 to 122 million bales in 2004-05.

As such, there is little if any comparison to be drawn with the current environment in which global output is expected to fall to 112 million bales this season, from 120 million bales in 2007-08.

Although the huge cutback in US acreage was the primary reason for this year's drop in global output, production in other major producing nations is flat and has not been able to compensate for falling US output.

Chinese output is down 1.5 million bales. The Indian harvest will be the same as last year. Local analysts' recent downward revision of the Pakistani crop by more than 10% has not yet been factored into the USDA's balance sheet. Pakistan is of particular significance because it is an importer and is faced with buying abroad or drawing down stocks, both of which have bullish implications for the market.

The estimate for global ending stocks was raised by 1.3 million bales in the September USDA report, to 52.32 million bales, or 42.3% of consumption, because of the downward revision to demand. Viewed in the context of other markets, a 42.3% carryout does not appear very alarming. Chart 5 shows clearly, however, that this is the level of global stocks that leaves the market vulnerable to price spikes.

As we have pointed out in the past, Chinese stocks account for close to a third of global stocks according to official data, but it does not seem to affect its foreign purchases, because imports continue to grow every year.

We continue to believe that cotton is probably the best example of a market that's taken a battering on account of the general selling of "everything," partly because of poorly calculated demand estimates and partly because of forced liquidation by all categories of traders. This kind of selling can still take the market much lower, so we recommend looking for a consolidation before establishing long positions. We are definitely bullish and believe that once the street understands the fundamentals, we will move substantially higher.

[September 18, 2008]

Chart 4 – Global cotton consumption and production

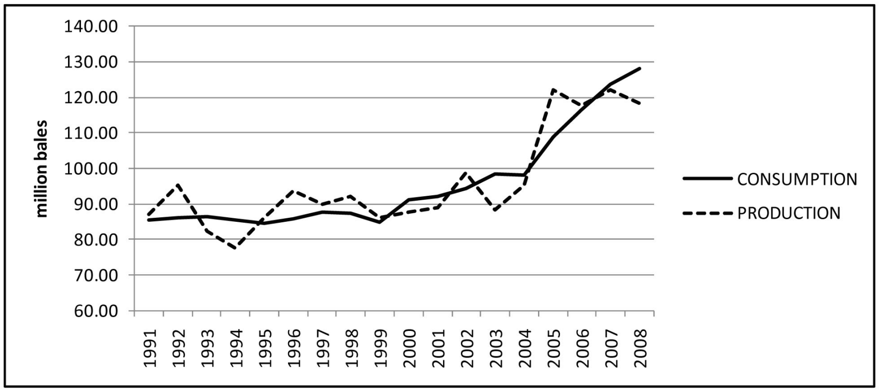
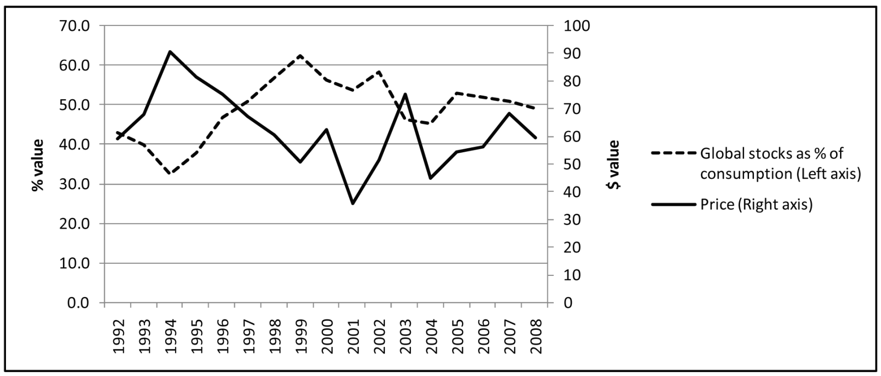


Chart 5 – Cotton stocks as a percentage of consumption, price



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