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Cocoa: king of agriculture

The cocoa market was a standout during the recent drubbing of commodity markets. Chart 1 shows cocoa prices outperforming the CRB Index by a wide margin throughout April. It is tempting to present this relative strength as evidence of our bullish case.

In early March the cocoa market participated in the broad commodity selloff, with a nosedive of more than $600 per tonne, or 20%, in the space of a mere four sessions (Chart 2). The steep drop served as a healthy cleanup of weak longs. Open interest fell to 132,000 contracts from a peak of over 180,000 contracts. The fund net-long position dropped to 36,000 contracts from 65,000 contracts. The market bounced back sharply, erasing most of March's losses, and most significantly, without a rebuild of the open interest – for the time being, anyway.

There hasn't been too much in the way of new developments on the fundamental front. The posted figures show that the 2007-08 Ivorian crop is running about 100,000 tonnes ahead of last year's pace, at 1.1 million tonnes. After adding 100,000-tonnes-plus of the beans that were counted as part of the 2006-07 crop, the main crop should be somewhat over 1.2 million tonnes.

The April through September mid-crop, however, is unlikely to reach the 300,000-to-400,000-tonne level of the past couple of years. Precipitation has been below normal, and it has shown in the early stages of the secondary season. The flow of mid-crop beans is usually in full swing by now, but this past week arrivals were 12,000 tonnes, down from 14,000 in the same week last year.

Although first-quarter grinding results may seem neutral on the surface, we see them in a bullish light. The US grind was down 5.85%, and the European grind was up 4.7%. But the European industry is more than three times the size of its US counterpart, so the strength in Europe is far more significant than the weakness in the US. The US grind was down to 91,876 million tonnes, but the European grind was up to 354,571 tonnes.

Shrinking US data were largely expected and are part of a trend of the shift of grinding activity to origin countries. US grindings have fallen between 5% and 10% in each of the past four quarters.

To illustrate, consider that US bean imports were down by about 35% in 2007 over the previous year. Imports of paste and butter were down a bit, while powder purchases were up a bit. Chocolate consumption, however, has been growing at a rate of between 4% and 5%, indicating that demand is strong and that we can no longer look to grind statistics – at least in the US – as the sole measure of consumption.

Malaysia, whose annual harvest at one point reached 250,000 tonnes of beans, has all but abandoned the growing business. This year it will eke out a crop of about 30,000 tonnes. But it has turned to the processing side of the industry. Grinding capacity is currently 270,000 tonnes, but plans are to increase capacity to 360,000 tonnes over the next two years. Most beans are imported from neighboring Indonesia, but talks are currently being held with Ghana to increase imports to ensure a steady supply of beans to feed the booming grinding business.

Most analysts are talking about a small global deficit for 2007-08. The swing factor on the supply side could be a disappointing Ivorian mid-crop. The vulnerability of hav-

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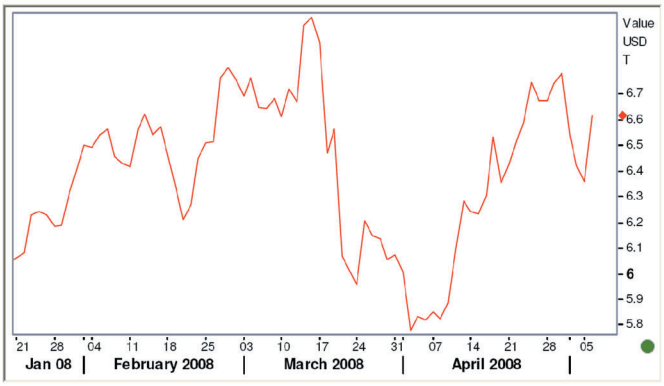
ing two thirds of global output grown under the same climatic conditions – which also happens to be a politically volatile region – is ever present. We're under no illusion, however, that the bull market in cocoa has not borrowed heavily from the momentum of the broader commodity bull market. Even if we have deficits on the global cocoa balance sheet, ending stocks are still equal to about 40% of consumption.

On the other hand, the significance of a general environment of rising commodity prices extends beyond the phenomenon of easily-excitable fund managers. The rise in price of virtually all input materials – from fuel to fertilizers – means that the cost of production has increased and probably with that – the floor price (or in trading terms, the support level) has been bumped up sharply. Traders should acclimate themselves to new price ranges for most commodities.

The swings in cocoa prices are large enough to trade, as recent history has amply illustrated, and we should not overstay our welcome when momentum seems to be waning. But we're not there yet. Despite the market's lofty level, we are not overbought – certainly when viewed through an analysis of the open interest.

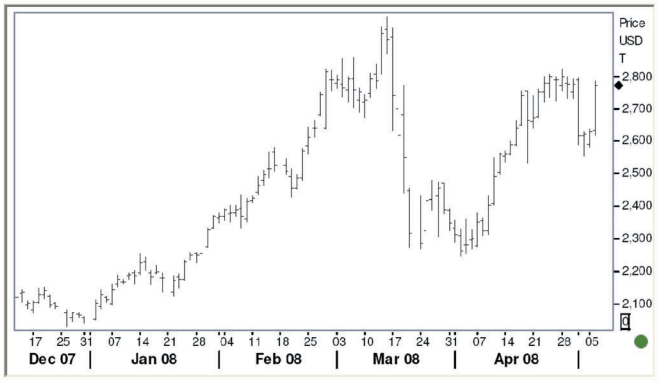
Remain long. *[May 7, 2008]*

Chart 1 – Cocoa/CRB Index



Courtesy: Reuters

Chart 2 – July cocoa



Courtesy: Reuters

SUGAR

Pathetically bearish action

You'd never know from watching the price activity (Chart 3), but the fundamentals of the sugar market are developing in the bullish manner we expected them to. Actually, there's more wrong with the market's action than meets the eye. The rally in the US dollar can't be blamed, because many commodity markets that have been battered in recent weeks have staged handsome recoveries. Some, such as corn and crude oil, have even soared to record highs. Leading up to the expiry of the May contract, the inter-month spreads collapsed, a clear indication that there is no pent-up demand (Chart 4). While the near-term outlook indeed seems bleak for bulls, we are confident that the bearishness will not last.

As we have pointed out in recent issues of *Focus on Futures*, the major sugar analysts have been behind in accounting for smaller-than-expected 2007-08 Indian production. Current estimates stand at about 27 million tonnes, down from earlier forecasts that reached as high as 33 million tonnes.

On May 7, The International Sugar Organization (ISO) released its most recent estimate of the global sugar balance sheet, lowering the surplus to 7.8 million tonnes, down from its April estimate of 9.3 million tonnes, which was down from its late-2007 estimate of 11.1 million tonnes, presumably largely on account of lower Indian output.

For 2008-09, Indian farmers have cut planted sugar area back sharply, and early estimates are for output of between 22 and 24 million tonnes. Domestic consumption of 21 million tonnes is closing in on output. Still, the recovery after the droughts of 2003-04 and 2004-05 is complete, and the government controlled inventories have been rebuilt. It is unlikely that India will play a significant role, if at all, in the export market. A significant percentage of global carryover stocks – which are about 50% of global usage and which bears are constantly reminding us of – consist of India's stocks, which are really not mobile and are not intended to ease world shortages. History shows definitively that India moved those stocks only to supply the domestic market in the two years of drought. Even in the couple of bountiful years that followed, exports never exceeded 3 million tonnes.

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The other development that we consider instrumental, and that will sooner or later ensure that sugar prices find support and start moving higher, is the Brazilian ethanol situation. We are now seeing estimates for the ethanol/food ratio of the cane crop at 57.3/42.7 in favor of ethanol, which is up from previous estimates of a ratio of 55/45. The cane crop is enormous, and sugar output will likely still be at or near a record. But the ratio is certainly much higher than anyone would have believed only months ago, and we do not believe that higher ethanol production is "in the market" to the degree that the ratio would indicate. With crude oil over $120 per barrel, crushers will be looking to meet the demand for ethanol, which is sure to grow, both for the domestic and export markets.

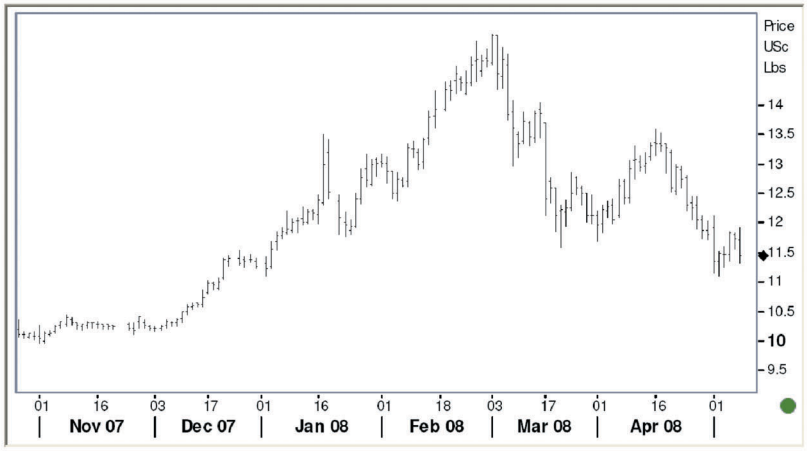
Another wrinkle that could be developing relates to high fructose corn sweetener (HFCS). Until the bull market in sugar in the 1980s, food processors used mainly sugar. When prices skyrocketed, the industry moved to the much cheaper HFCS. Before the bull market in corn began in 2006, HFCS prices were about 15% below sugar prices. Now HFCS is being quoted about 7% above sugar. Some smaller food processors have been quick to make the switch. Companies such as Coca-Cola and other large food manufacturers, however, are not going to jump and risk antagonizing loyal consumers. But if the spread between the two sweeteners does not stabilize, we can be sure that food manufacturers will increase their sugar usage.

ISO's early forecast for the 2008-09 marketing year calls for a global deficit of 1 to 2 million tonnes. The tide is turning.

The picture is sort of ugly at present. We can't provide much of a reasonable explanation that matches our bullish fundamental case. Nevertheless, we believe this is the time to be buying. Aside from taking a long position in futures, we also believe that buying out-of-the money call options is appropriate, given the magnitude of the move that we expect.

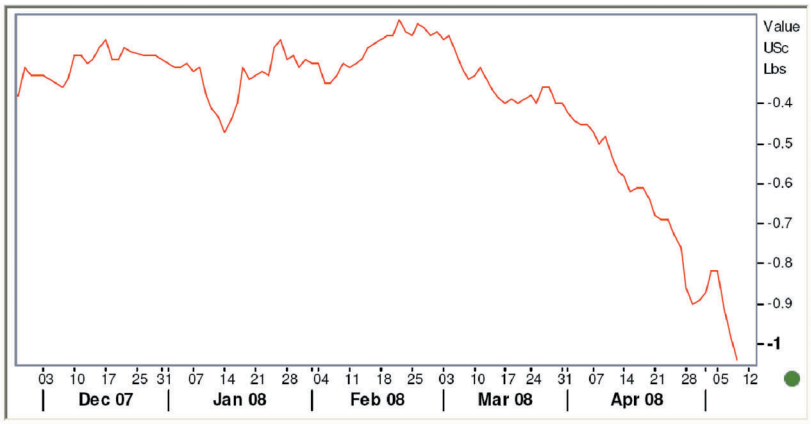
[May 9, 2008]

Chart 3 – July sugar



Courtesy: Reuters

Chart 4 – July October spread



Courtesy: Reuters

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WHEAT

Is this still a bull market?

Wheat prices have tumbled by a bear-market's worth of losses. The market has fallen by close to 40% since the high was set in mid-March (Chart 5). As we will demonstrate, the supply/demand fundamentals remain bullish in terms of balance sheet tightness. The issue to be addressed for this, and all commodity markets, is: Have prices increased sufficiently to ensure that producers will create adequate supplies?

We're just completing yet another marketing year that saw further depletion of the world's wheat supplies. Production of 606 million tonnes against consumption of 620 million tonnes pulled global ending stocks down to 110 million tonnes, or 17.7% of consumption, a record low. There have been plenty of bullish developments while prices have been dropping, but the market is focusing strictly on the future. According to the most recent planting intentions report released on March 31, farmers of the world's biggest exporter, the US, planted 46.84 million acres of winter wheat, up from 44.987 million acres in 2006-07. Although prices rallied sharply for about a week because the market was expecting significantly more acres, the downtrend resumed soon enough. Battling export restrictions by major exporters such as Kazakhstan and Argentina, bulls couldn't even get far past the morning headlines as the market continued its precipitous decline.

Millions of tonnes	USDA 2007-08	USDA 2008-09
Argentina	15.5	15
Australia	13.1	24
Canada	20.05	25
EU-27	119.48	140
Kazakhstan	16.6	14
Russia	49.4	52
Ukraine	13.9	20
US	56.25	65.10
Total	**304.28**	**355.10**

How are things shaping up as we begin to harvest the Northern Hemisphere winter wheat crops that will shape the 2008-09 balance sheet? The USDA gave us its first comprehensive look at the 2008-09 marketing year in the May supply/demand/ situation report. The accompanying table shows expected 2008-09 production for major exporting countries.

US

The estimate for all US winter wheat categories was 1.778 billion bushels (48.45 million tonnes (MT)), above the average of analysts' estimate of 1.707 billion bushels (46.5 MT). Including the spring wheat crop, the total US crop is forecast at 2.3912 billion bushels (65.2 MT) against guesstimates of 2.312 billion bushels (63 MT).

There were recent surveys that showed yields in key regions were improving, but the robust estimate was still a surprise. As of the most recent weekly crop progress report, the good-to-excellent portion of the US winter wheat crop was 47%, compared with 57% at this time last year. Total yield for winter and spring wheat was estimated at 42.5 bushels per acre (bpa), compared with the average of the past two years of 39.6 bpa, and the average of the past 10 years of 41.17 bpa. It is not a record – the yield in 2003-04 was 44.2 bpa – but still caught traders off guard.

Global

Most of the estimates for key producing nations were in line with previous expectations. Sharp recoveries in drought-stricken regions such as Australia and Europe will yield a record global crop of 656 million tonnes, above the International Grain Council's April 24 estimate comprehensive estimate of 645 million tonnes.

The market certainly saw the report in a bearish light. However, global demand is forecast to grow to a record 642 million tonnes, up from 620 million last year. This will be only the second season in 10 years in which there will be a meaningful global production/consumption surplus. Ending stocks as a percentage of consumption will increase to 18.9%, which is hardly what we need to feel comfortable that the supply issues we experienced this past season have been adequately dealt with.

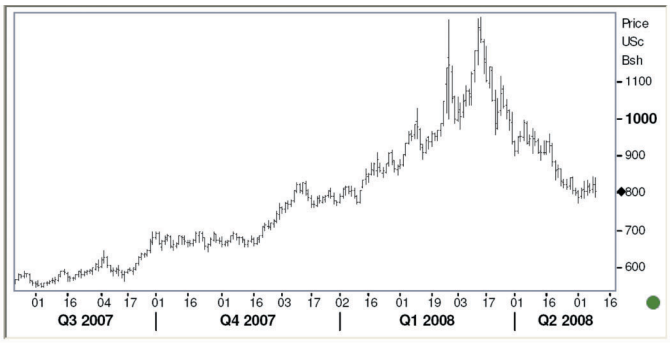
The USDA has been generous with its estimates, which are based on acreage and trendline yields. This means that crops are still vulnerable to weather conditions. In any case, global inventories remain at the second lowest level in history.

Trading strategy is tricky. We are now in a clearly defined intermediate-term downtrend. Even after the huge losses we're still trading at more than double average historical price levels. We will feel more comfortable paying up when and if the market turns up before we recommend fresh long positions.

The increase in global demand for food-quality grains will place hard red winter wheat and other bread-quality varieties at a premium. Kansas City Board of Trade wheat has fallen significantly *vis-à-vis* Chicago Board of Trade wheat (Chart 6), and we believe that this represents a perhaps less profitable, but more conservative, trading opportunity. So, as an alternative strategy, buy December Kansas City wheat spread against December Chicago Board of Trade wheat.
[May 9, 2008]

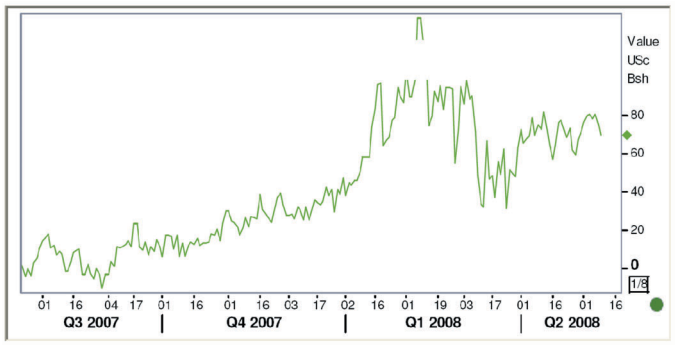
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Chart 5 – July wheat



Courtesy: Reuters

Chart 6 – Kansas City/Chicago wheat spread



Courtesy: Reuters

SOYBEANS

High prices have neither rationed demand nor inspired enough new production

Every year, the USDA begins publishing new crop forecasts in its May supply/demand situation report, for both the US and foreign producers. For the soybean market, the US is covered, but foreign production coverage doesn't start until June. This is because foreign production really means Brazil and Argentina, which combined grow about 50% of the world's soybeans, and they don't start planting their new crop until autumn, so there isn't very much to report on, even in terms of intended acreage.

A little background: Ever since January, the soybean market has made a lot of noise. November beans ricocheted between $10.66 and $14.77 per bushel, but headed into the May report at the same price it began the year. The most recent issue that traders were grappling with and that set the tone of market activity leading up to the report was the poor planting weather for corn, which has a smaller window for getting its crop planted. It was assumed, then, that soybean acres would benefit and we would see a larger crop than would have been otherwise indicated by the March 31 planting intentions report. Apparently, though, there was an ample supply of surprises, on the US side alone, to send new-crop November beans to its highest close since March 13 (Chart 7).

First, US soybean exports were not expected to repeat the record set in 2006-07 of 30.43 million tonnes. Foreign sales kept surprising, however, and the USDA has been playing catch-up all season long with its forecast, which as recently as January stood at just over 27 million tonnes. Commitments as of this past week are up to 28.89 million tonnes, ahead of last year's sales at this time of 28.14 million tonnes. Shipments stand at 25 million tonnes, just a tad below the 25.66 million tonnes seen last year at this juncture of the season, but with close to four months to go until the end of the marketing year.

Given the strong pace of sales, the USDA once again raised its estimate for the year. In its May report it estimates exports at 29.67 million tonnes, up from its April forecast of 29.26 million tonnes. We may not take over last year's record, but we're certainly selling many more soybeans than anyone would have believed just a couple of months ago.

As a result, the estimate for US ending stocks was lowered to 3.95 million tonnes, or 4.79% of usage, just slightly higher than the modern day record low of 4.5% set in 2003-04.

The real problem lies in the future. Even with an estimate for a near-record yield of 42.1 bushels per acre, the 2008-09 crop is forecast at 84.6 million tonnes. With a relatively modest 28.6 million tonnes estimated for exports, ending stocks would be 6% of consumption, hardly what we needed to see for a crop that should be replenishing a severely tight market.

Normally, at this time of year, we would see relief for a tight soy market, because the South American crops are in full harvest. This has been compromised, however, because of political unrest in Argentina. The Argentinean government is trying to raise export taxes on agricultural products to conform to rising international prices. The government action has sparked strikes among farmers, limiting the amount of beans available for export. At the moment, the mammoth South American crops are not alleviating the tightness. While strikes do not last forever, the situation cer-

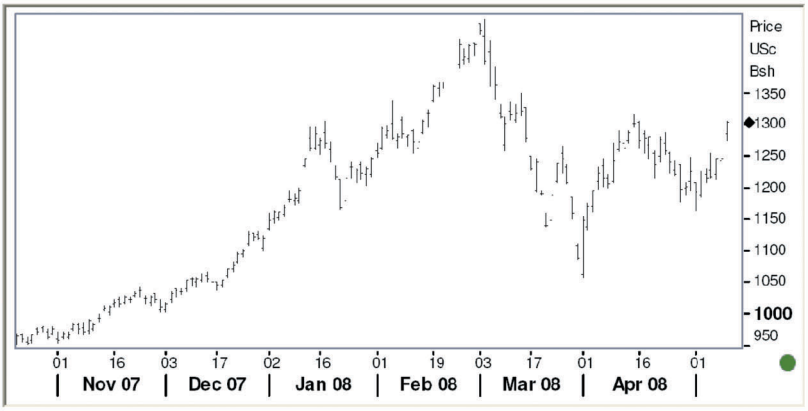
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tainly does have the effect of exposing how vulnerable this market is. If we get poor weather in the US while the strike is still on, prices will continue to soar.

We have not participated on the long side of this bull market, because we always believed that South America crops would eventually bridge the gap between the 2007-08 and 2008-09 US crops. It is now obvious that we were wrong, and certainly anyone who was fortunate enough to be long should remain so. The risk of entering the long side now has increased. Nevertheless, a reasonable strategy would be to buy November soybeans and risk only the close of the session before the May USDA report, or $12.75 per bushel. The momentum created by the report should not be lost.

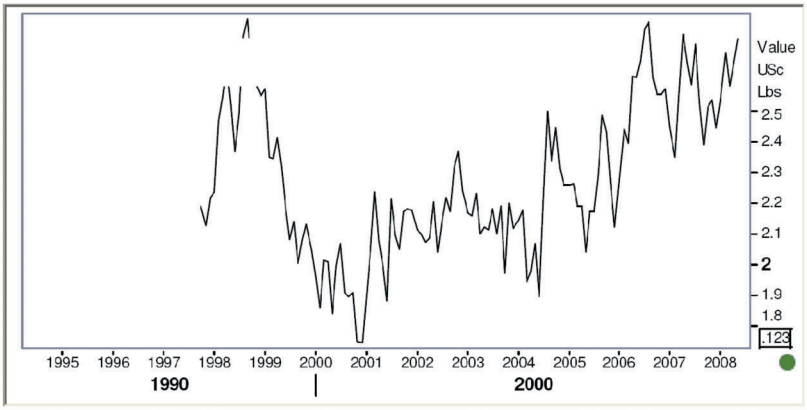
An alternative strategy would be to spread soybean oil against soybeans. Chart 8 shows the beanoil prices are now challenging their historical highs when expressed in soybean terms. Beanoil may very well move to unprecedented highs while the soybean market acclimates to the reality of bio-diesel taking an ever increasing share of soybean crops away from the feed side of the market. Tightness in oil may persist even if bean prices fall. Buy December soybean oil and sell November soybeans. *[May 12, 2008]*

Chart 7 –November soybeans



Courtesy: Reuters

Chart 8 – Monthly soybean oil/soybeans



Courtesy: Reuters

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