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US wheat supplies slide

On September 30 the USDA released two reports. Both provided a bullish jolt to the wheat market, which had been consolidating fresh multi-month lows in the weeks leading up to the report (Chart 1).

The Quarterly Stocks report showed that stocks of all three principal US agricultural products – corn, soybeans, and wheat – were lower than expected. US wheat inventories on September 1 stood at 1.919 billion bushels. This was well below the average of analysts' guesstimates of 1.973 billion bushels.

In September, along with the inventory report, the USDA also releases a revised post-harvest estimate for wheat; the other crops are still being harvested.

The street was expecting a downward revision from the USDA's August 12 monthly supply/demand situation report of 2.167 billion bushels. But the estimate came in at 2.098 billion bushels, well below the average guesstimate of 2.14 billion bushels.

As a result of the supply-side revisions contained in these two reports, 2005-06 ending stocks will be trimmed by at least 69 million bushels. If we assume that traders' expectations of inventories were a reflection of current USDA data, then we can deduct a further 50 million bushels or so. As a result, 2005-06 global ending stocks will be slashed by over 3 million tonnes.

Other regions to keep an eye on for revisions in tomorrow's USDA monthly supply/demand situation report are Australia and India.

Australian production was recently revised downwards slightly by local analysts, to just under 24 million tonnes. The USDA, however, was well behind reality with its September pre-season estimate of 21.5 million tonnes. Weather conditions have improved significantly, and Australian output for 2005-06 is set to recover to its potential.

It will be interesting to see the USDA estimates for Indian imports for 2005-06. India has always been self sufficient in wheat, but a growing population has increased demand. Output, however, is expected to be about the same as the previous season's 72 million tonnes. So far, the USDA has used a conservative import estimate of 1 million tonnes, but market reports are indicating that the government is set to clear a prohibitive import-tariff system to make way for imports of 2 million tonnes.

As it is, the global balance sheet has been tightening despite last season's huge jump in output. Early projections for 2005-06 ending stocks in the September USDA supply/demand situation report were 139.66 million tonnes, or 22.6% of consumption. This estimate was down from the August estimate of 23% consumption, and from 2004-05 ending stocks of 24.2% of consumption.

Based on the anticipated revisions discussed above, we could see the estimate for 2005-06 global ending stocks fall by close to 2 million tonnes, which would bring the stocks-to-consumption ratio down another notch to 22.3%, which is where we were in 2003-04 when wheat prices ran up to $4 per bushel.

Demand has been somewhat better than expected but for the most part is line with the USDA's forecast for US exports to fall by 8.3% for the season. Weekly commitment data show that we're slightly ahead of that pace, with contracted sales down only 7.5% from the same time last year.

Wheat prices have charted an independent course in recent months and have been much stronger than the other

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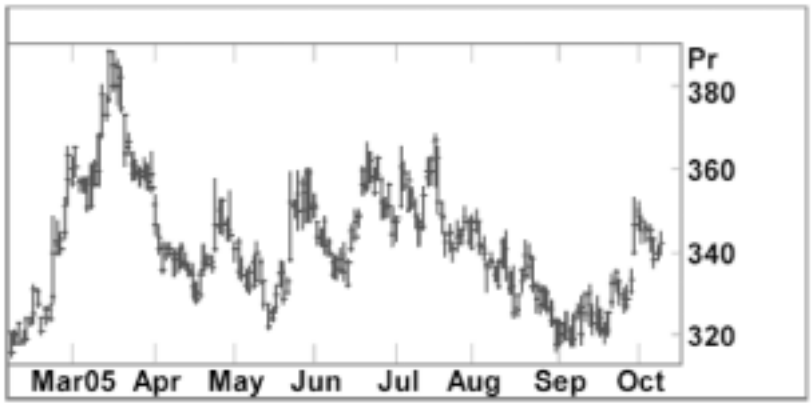
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grains. Chart 2 shows that the wheat/corn ratio is at the high end of its multi-year range. This could actually be short-term bearish for domestic consumption to some degree, because it means that demand for the feed portion of the wheat market should taper off in favor of corn. But for the longer-term, it is bullish, because the supply/demand fundamentals prevailed even in an environment when funds were heavily short this market. Commitment of Trader data show that funds have begun to cover their net-short position.

A tightening balance sheet and an imminent short-covering rally keeps us bullish. Maintain existing long positions.

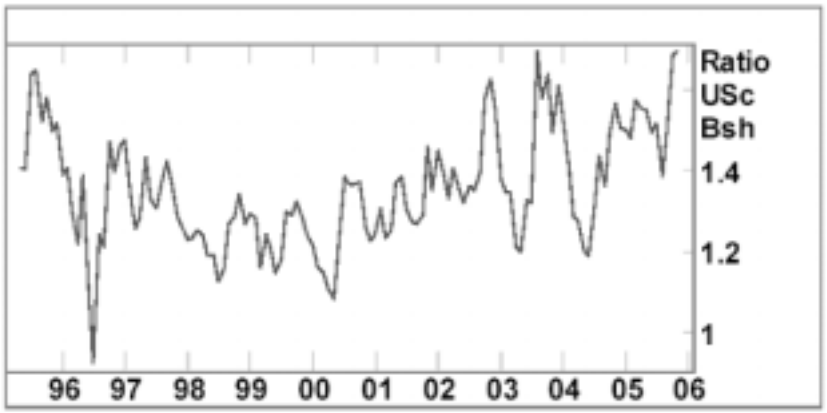
[Oct. 11, 2005]

Chart 1 – December wheat



Courtesy Reuters

Chart 2 – Wheat/corn ratio



Courtesy Reuters

COCOA

A bigger Ivorian crop vs. strong demand

Cocoa prices are poised to break below the long-held $1,300-per-tonne support level (Chart 3). Do the underlying fundamentals support a bounce, or are we justifiably about to begin a fresh down leg?

On the supply side: As expected, early results for the 2005-06 marketing year are favorable. As of October 23, arrivals at the two Ivorian ports totaled 113,664 tonnes, significantly more than arrivals of 28,565 tonnes at this time last season. At this time, the arrival data are not terribly meaningful yet, unless they continue at this pace.

Beans matured early because of beneficial precipitation. This also bodes well for a longer mid-crop season. Clearly, the early results are an indication that Ivorian output will recover from last year's mediocre harvest.

On the other hand, farmers who may have abandoned any hopes of seeing higher prices are rushing whatever beans

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have been harvested to port, hoping to avoid delays caused by renewed civil tensions. To get a feel for the political scene in the Ivory Coast, consider the following summary of the events of the past several days:

The five-year presidential term set forth by the Ivorian constitution ended on October 30, and elections were to be held. President Laurent Gbagbo remained in office, and there were no elections. Although the UN-brokered peace plan made some provisions for a 12-month extension of the presidency, during which elections would be held, the opposition was unhappy with the president's decision to exercise that extension and demanded that he step down. The ensuing rally in support of ousting the president was kept peaceful by means of tear gas fired by government riot police.

Judging by the market's weakness, traders seem to feel quite confident that the infrastructure that facilitated the growth, harvest, and shipment of full-size crops ever since tensions erupted in 2002 will continue to function normally. The erasure of a premium – which seems to be in the works – for the potential sudden eruption of violence and disruption to the flow of cocoa beans makes the market vulnerable to equally sudden rallies.

It is very early in the season, and the major analysts have yet to weigh in with specific output estimates for the Ivory Coast for 2005-06.

Demand indicators have been positive. The third-quarter European grind was 8.6% higher than the third quarter of 2004. The US grind was a disappointment, rising only 0.44%, compared with the 5% increase that traders were anticipating. Overall, though, after including the steady growth in origin grindings, consumption seems to be growing faster than the 3% growth rate of 2004-05.

While the market is still suffering from the drag of burdensome powder supplies, demand for butter has not been affected. Cocoa butter has maintained a close-to-all-time-high ratio of three times the London spot price.

At 143,000 contracts, open interest is up at its highs again. Commitment of Trader data show that commodity funds covered their short positions in early September, but are now reestablishing a short position, which means the market can easily drop substantially once the lows are broken. If support emerges, the shorts will once again scramble to cover.

To summarize, the principal supply/demand issues can probably be best described as inconclusive. Over the next two months or so, we'll have a more accurate picture of the size of West African crops. We should not dismiss the possibility of supply interruptions caused by political upheaval, simply because it has not proven to be a factor in the past. Bears who choose to focus on a very *technically* bearish situation should tread cautiously. *[Nov. 1, 2005]*

Chart 3 – Nearest contract cocoa



Courtesy Reuters

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COTTON

A dip in supply and a rosy export outlook

Cotton prices rallied 10¢ per pound from mid-August through early October mainly because of supply side factors (Chart 4). The market received some support from the deadly hurricanes in the US. There is some evidence of crop damage, but it is unclear whether it was significant. Next week's monthly USDA supply/demand situation report should shed some light on this issue. The bigger story was inclement weather in China and a downward revision to the Chinese crop.

To better understand this summer's rally, consider a bit of history: Early this decade, the cotton market ushered in a new era. Technological advancements, which improved mobility, and a growing gap between labor costs in industrialized and Third World countries had caused a lot of manufacturing activity to shift to Asian and South American countries. Nowhere was this more evident than in the cotton market. US mill consumption fell, but exports rose. The cotton then found its way back to the US in the form of clothing and textiles. The sudden drop in US mill consumption that ensued was therefore not alarming, because it was understood that whatever domestic consumption was lost in the US would be compensated for by Chinese purchases to feed its mills.

Then, China grew a record 29-million-bale crop in 2004-05 – 30% larger than the previous year's – and it was feared that foreign demand for US cotton would plummet. This explains the huge drop in prices – from 80¢ to 40¢ per pound – which began in the summer of 2003 and ended earlier this year (Chart 5). Yet another new era was developing in the cotton market, which would see China's reliance on cotton imports plunge dramatically.

But that was not quite the scenario that unfolded. The US sold a record 14.4 million bales abroad in 2004-05. China continued to be a major customer for US cotton. For the season, US exporters shipped over 3 million bales to China. Now, this was 1.5 million bales below 2003-04 Chinese sales, but that was to be expected, considering that the Chinese crop was so large. Prices stopped falling. When the USDA's early estimates for Chinese imports for the new crop year came in at 15 million bales, more than double 2004-05 imports of 6.4 million bales, the strong rally followed.

To complicate matters, the weather turned on the Chinese crop in September. In July the USDA estimate for the 2005-06 Chinese crop stood at 26 million bales, but by October, that estimate was down to 24.5 million bales.

US export commitments to China this season stand at 3.1 million bales as of last week's export report, compared with a paltry 400,000 bales at this time last year. Overall, the USDA's forecast for an 11% increase in annual US exports is slightly below commitment data indications, which are 14% ahead of last year's pace.

Statistically speaking, there isn't much reason for prices to continue to rise much from here. Global ending stocks are 51 million bales, which represent a burdensome 45% of consumption. This compares with last year's 47% and 41.7% in 2003-04. The market may very well have fallen into a trading range bounded by 50¢ per pound on the downside and 55¢ on the upside.

The export forecasts are on the optimistic side. A careful following of weekly data will allow traders to monitor the progress of the demand side.

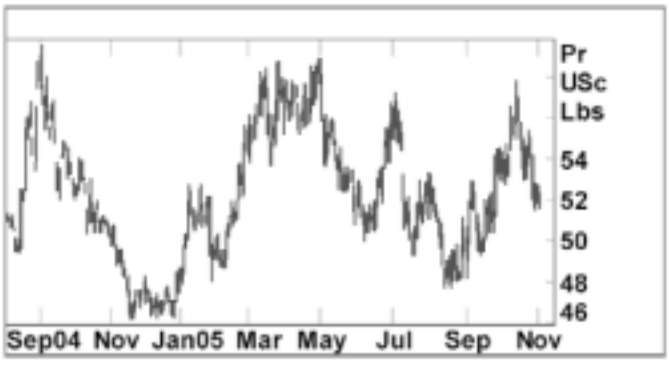
It will also be interesting to see what the USDA does with both US and Chinese production estimates in the November report, which is scheduled for release on November 17.

The summer rally alleviated a very oversold condition in terms of open interest. Commodity funds were net-short 25,000 contracts. They have now moved to a small net-long position.

The major crops are likely to be somewhat smaller than reflected in the current balance sheet. If export forecasts are met, we believe the market will gradually work its way higher. Use setbacks to establish long positions.

[Nov. 2, 2005]

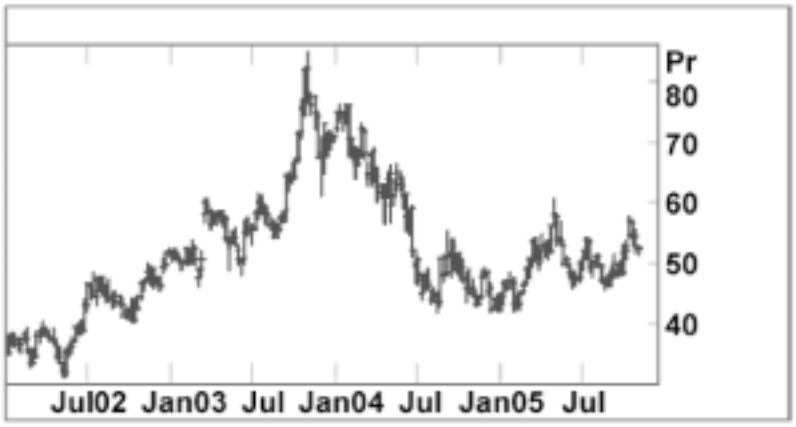
Chart 4 – December cotton



Courtesy Reuters

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Chart 5 – Weekly nearest contract cotton



Courtesy Reuters

SOYBEAN OIL

Will bio-diesel demand tighten supplies?

Crude oil prices have tumbled by over $10 per barrel over the past two months, or roughly 15% from the peak set in late August. Natural gas hung in a bit longer, but is now about 20% below its highs. The challenges presented to corporations that are heavy users of energy products and to the average consumer, however, have not disappeared. Prices are still dramatically higher than they were up until mid-1994 when the market broke above the 1990 highs. A detailed discussion of the petroleum market is beyond the scope of this article.

Still, we think that it's safe to say that even if crude oil were to drop an additional $10 per barrel, the drive towards commercial viability for alternative fuels would not be compromised all that much. Petroleum refineries were running at capacity in the US even before hurricanes wreaked havoc along the coast of the Gulf of Mexico, and once all facilities are back up and running, we return to the original problem. Petroleum prices may consolidate at these levels or higher, and that would certainly underpin efforts to develop non-petroleum based energy sources.

Focus on Futures has discussed bio-fuels as they relate to sugar- and corn-based ethanol, which is used as a gasoline blend, but we have not made any mention of soybean oil fuel usage, which is used in conjunction with diesel. It's a smaller market, so not as much hard data are available as there are with corn and sugar. The USDA, for example, has not yet created a separate category for soybean oil fuel usage the way it has for corn.

On the surface it would seem that this relatively new and growing market for soybean oil should be bullish for both soybean and soybean oil prices.

Since the beginning of October, soybean meal prices have outperformed soybean oil (Chart 7). But that was merely a correction in a much longer-term trend, which has seen oil prices strengthen against meal, at least since the beginning of this decade (Chart 8). This has been used as technical evidence that a period of competition for soybean oil supplies between the food and fuel industries is materializing.

Although it is clear that the use of bio-fuels will continue to grow, the effect on supply of soybeans may have been somewhat overstated.

First of all, the incentive to invest in refinery and delivery infrastructure is weak. We're not talking about the mature ethanol market in Brazil. But in the US, although a degree of commercial viability has been achieved, it is completely dependent on government subsidies. Without government programs, the cost advantage over petroleum fuels barely exists.

Furthermore, there's been a very successful campaign to turn food processors away from the use of trans fats, which are found in vegetable oils such as soybean oil. There has been a massive shift to healthier oils. Canola oil has made significant inroads in the vegetable oil market, for example. In an interview we conducted with a bio-diesel trade organization, we discovered that whatever increase in soybean oil usage has been attributed to diesel, a similar amount has come out of food consumption. Growth in fuel usage would only tighten supplies and be bullish for prices if it were growing at a faster pace than

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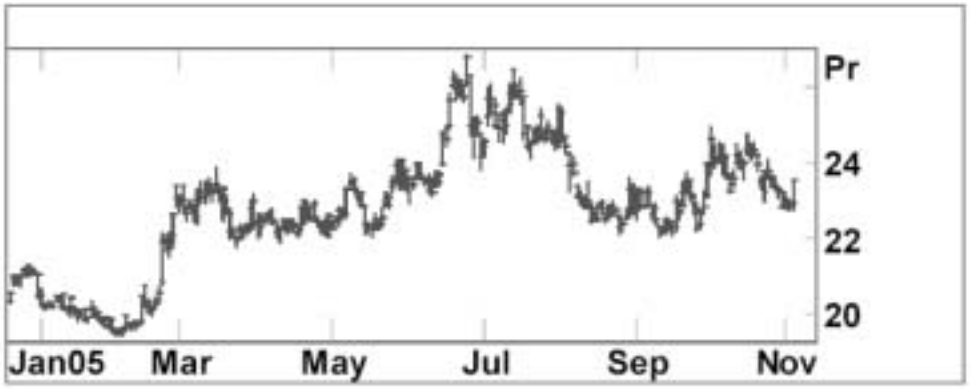
food consumption was falling. But that is not happening in the current environment.

There are close to 50 production facilities in the US at present. Thus far, the diesel additive is used primarily by government agencies that use fleets of cars, trucks, and buses.

Down the road, a more developed market will be a bullish factor. It is difficult to see right now how that will happen – as illustrated. Nevertheless, if the concept were really to take hold, pressure on soybean oil supplies would certainly emerge.

A conservative approach to trading this market from the long side as a long-term position would be to trade soybean oil as a spread against soybean meal. The recent dip we saw in that spread presents an opportunity to establish a conservative long position in soybean oil. *[Nov. 4, 2005]*

Chart 6 – December soybean oil



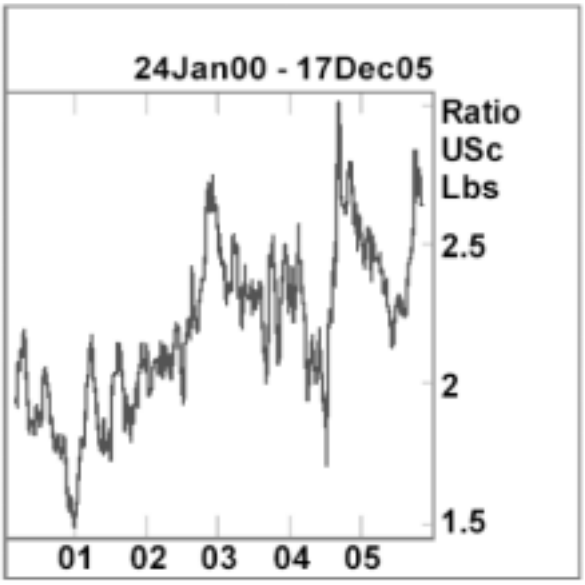
Courtesy Reuters

Chart 7 – December soyoil/December soymeal



Courtesy Reuters

Chart 8 – Nearest contract oil/meal



Courtesy Reuters

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