

November 7 2010

ANOTHER ONE BITES THE DUST

Drought in Russia, Kazakhstan, Ukraine and W. Australia. Floods in Eastern Europe and Pakistan. Excessive rains in Canada, the U.S. Midwest and E. Australia. It appears that the Good Lord is playing skittles with some of the world's most important grain crops. The hard red winter crop in Kansas looks like it will go into dormancy in the worst condition in many years. Another one bites the dust? In the Middle East the drought in Syria, Iran and Iraq continues with the planting window for wheat just four more weeks; the next ten days look bone dry. The same forecast holds for Manchuria where the wheat plantings are struggling in very dry conditions. And another one, and another one. Another one bites the dust. The Russian wheat crop is poorly established and highly vulnerable to winterkill, and with the strongest La Niña in 70 years, we'll be lucky to get normal crops out of southern S. America this year.

Meanwhile the US corn harvest is virtually complete and it is almost certain that the USDA will have to further reduce the yield in next week's report and probably again in January. I believe that only two States will have a higher yield than last year, North Dakota and Wisconsin. The average estimates for the final corn yield this year are Surprise! Surprise!.... clustered around October's USDA's estimate of 155.8 bushels per acre. The herding instinct is a very powerful primeval urge amongst the analysts. With many thousands of yields painstakingly collected over the last three months, it has become obvious to me that the yield in the eastern belt continued to drop off through harvest, and fell well short of expectations in the western belt. In the October crop report the USDA claims to have had 91% of their test plot data, which seems extraordinary given the immaturity of the north western belt at that time. This month the USDA will use that same data as well as over 20,000 farmer surveys, as they did in October. I do not know how the USDA weighs these two sets of data, but I do know that the farm reports in November will be considerably lower than those in October. For instance since early October I have seen a drop off in Ohio, Wisconsin, Indiana, Missouri and parts of Iowa of more than 10 bushels an acre. Michigan has dropped by more than 7. I expect the USDA, in their usual manner, to stair-step the yield down 2 to 3 bushels now and 2 to 3 bushels in January. I continue to believe that the final yield will be below 150. Mark every 2011 corn stocks report on your calendars.

Two weeks ago the USDA came to Chicago for their usual dog and pony show. I did not attend because my cardiologist does not like me to get all het up, and I certainly would have blown a vessel when they stated that the Chinese corn stocks are 60 million tons. Last year the Chinese government released 20 million tons of corn into the domestic market in an unsuccessful attempt to stem prices. The current price of newly harvested corn in China is over \$8.60 per bushel. Most analysts inside and outside of China believe the government stocks are down to around 10 million tons. The USDA continues to use Soviet era statistics. Start with a comfortable carry-out and work backwards, and if that doesn't work, add a zero. I would bet the USDA that the true number is closer to 60 million bushels not 60 million tons. If I lose the bet, the USDA

gets to own my home, or my Subaru, whichever they deem to be more valuable. If I win, I get to turn the gigantic USDA building in Washington into a refuge for the homeless, thereby solving two problems at once. Please read today's (Nov. 7) front page article in the New York Times about cheese consumption in the U.S.A. The article suggests that the USDA, who are meant to be the national obesity police, funds the campaign to encourage people to stuff themselves with saturated fat through the consumption of cheese pizza, which, the article suggests is one of the biggest causes of obesity today. It is a most damning report of a huge government agency at cross purposes, the left hand not knowing what the right hand is doing. Dairy Management, funded by the USDA, suggested for years that high dairy consumption facilitated weight loss. They are the people behind the Got Milk? advertising. Should it be Got Fat?

It has become screamingly obvious that China will soon have to import large quantities of corn. Their demand for soybean meal is growing at a rate of 7-8 million tons per year, which would imply that corn for feed should be growing at a rate of about 12 million tons a year. Add 2-4 million tons growth in industrial use, and Chinese increase in demand for corn is probably above 15 million tons per annum. The USDA claims that the increase in Chinese corn usage, for food and industrial use combined, is 4 million tons per annum. By being very high in some numbers and very low in others, maybe the USDA figures they will average out ok in the end. The Chinese have obviously got the USDA wrapped around their finger. The cynic in me, and that is about 99% of me, says the Chinese are already buying. Recent put selling in corn options looks suspiciously like the Chinese put selling we have become accustomed to in the bean options in the last few years. The corn open interest has risen from 1.1 million contracts in July, to 1.65 million contracts today. Remember, when the Chinese kick the tyres they are not looking to buy the car, they are about to buy the dealership. An era has begun in which China is self-sufficient in one commodity only, U.S. Treasuries. As far as I know, the last thing the Chinese actually invented was gunpowder, and yet they are the sellers to the world of all tech goods lowend and high. It is not just through hard work but by "borrowing" technology that they have achieved this status. Do not expect them to politely signal when they need to buy corn. They will make the Russian Grain Robbery of 1973 look like a bungled amateur job. My sense of smell tells me that the Chinese Lunar New Year is about to usher in the Year of The Rat.

With a sub 150 corn yield, a carry-in 250 million bushels below the official estimate, thanks to co-mingling of new crop in the Sep stocks report, and using 2.250 billion bushel corn exports, minimum, to accommodate Chinese buying, and to offset the lack of corn exports from Ukraine, my carry-out at current corn prices is negative. At today's usage we will effectively run out of corn next July. With demand approaching 1.2 billion bushels per month a minimum pipeline requirement would be 800 million bushels. With nothing to trade, we could turn off the screens and have an extended European style vacation, coming back mid-September if the crop is early, like this year, or mid-October, if the crop is late, like last year. Alternatively, we will ration domestic usage severely to make it into new crop. It is assumed that ethanol will take the big hit, but ethanol has now become a fully integrated part of the gasoline blend. The U.S. refiners are set-up to produce gas at only 86 octane and ethanol gives the octane the necessary boost.

Current ethanol margins are very healthy, and ownership of corn probably stretches into January. Even if the price of corn rallies to \$7, I think it unlikely that the ethanol grind will go lower than 4.5 billion, versus the USDA's estimate of 4.7. Currently the annualized ethanol grind is running at over 5 billion. That means a huge rationing process must take place in the domestic feed industry. Today chick placements are running 7 to 8% above a year ago, and while margins in hogs and cattle are getting hurt, we have not seen a major slowdown in these areas yet, but clearly the domestic feeding industry will have to be eviscerated. It is about time that we sat down at the kitchen table and had a major debate about ethanol. Is it really wise to use 40% of the U.S. corn crop, or 120 million tons for ethanol? Whether China buys 10 million tons of corn or not this year, they, with their handkerchief sized non-industrial farms will fall far short of domestic demand in the next few years. Since 2005, 300 million Chinese, almost the population of the United States, has migrated from rural areas to the cities. What if Chinese corn imports follow the same trajectory as soybean imports? And why wouldn't they? 60 million tons corn imports by 2015? By then we might as well chop up the kitchen table for fuel as we will have no need to sit there any more. Personally I would rather keep my food in a fridge, not a vault.

I listened to a very interesting presentation a few months ago by Evelyn Browning, a climatologist. She said the world was exiting a 40 year period of the most mild weather known in the last 1100 years judging by tree rings. With increasing sunspot activity on the rise, record warm Atlantic and Pacific ocean temperatures and a change in the Pacific Decadal Oscillation we have now entered what is historically a more normal but actually more violent and extreme weather regime which will probably last for at least 20 or 30 years. Certainly this year's droughts and floods, following so shortly on the heels of worldwide floods and droughts in '07 and '08 appear to validate her ominous predictions. When I got into the grain business in 1973, every four to five years for the next 15 years, we had a good old-fashioned drought in the Midwest. The last one was in 1988. Will it take another 1988 before we stop this ethanol madness? Consider that ethanol uses about as much energy as it provides, if you count all the transportation costs starting with imported fertilizer, of which we imported 11 million tons in 2009. Self sufficiency through ethanol? You betcha! Ethanol is nothing more than a giant subsidy to big agribusiness and another Washington boondoggle. It is very much like the USDA pushing saturated fat down our throats for our good health. It may make us feel good but it isn't doing any good.

Just a couple of years ago the prevailing wisdom was that the scientists were engineering crops that were about to be bulletproof and weatherproof. This year's collapse of the U.S. corn yield suggests that they may have over-engineered the latest hybrids. In tests in Illinois and Tennessee non-GMO corn out-yielded, on average, GMO corn. But it looked good in the lab! We have a truly extraordinary set of circumstances today; a question mark hanging over the corn yield; a voracious, insatiable appetite for all commodities from Asia; a global currency race to the bottom with our Central Banker at the controls of the helicopter, blindfolded; a weather regime that looks like anything but normal; a gigantic, well informed, hedge fund presence; and a permalong in the form of index funds. Add to all of the above the lowest, or second-

November 7 2010

lowest wheat and coarse grain stocks amongst major exporters in recent memory. We better not have any more crop problems, anywhere.

In a survey last month some 70% of European, and 50% of American respondents blamed speculators for high grain prices. Not droughts, not floods, not government sponsored programs like ethanol, not devalued currencies, not China's appetite, not low grain stocks. Maybe the world needs a touch of good old-fashioned starvation to knock some sense into it.

Three of my favourite sayings on the Board of Trade floor over the last 30 years are the following:

1. "Amateurs open the markets, professionals close it." This sort of went out of the window with electronic and nighttime trading.
2. "I bought the first break, I bought the second break, I was the third break." This one still holds true today.
3. "The cure for high prices is high prices." This should still be true today but how can you understand the game when they keep on moving the goal posts every few minutes. Just two years ago \$12 soybeans were considered to be an extreme rationing price. Today \$12 soybeans afford the Chinese soybean crushers \$3 profit margins. Five years ago \$12 soybeans would have encouraged the Brazilian farmer to open up the Cerrados to large scale production. But with the Brazilian real up 35% since then, he is not looking at \$12 but sub \$8. Throw in transportation and inflation, and the necessary acreage expansion is not yet happening. The cure for high prices is not simply high prices any more, but much higher prices, and how high that might be, we are possibly about to find out. The answer, Good Reader, will surely scare you.

Regards,
John Macintosh
November 7, 2010