Weathering the Storm: Support for Agricultural Commodities in the Medium-Term

"History is, in its essentials, the science of change. It knows and it teaches that it is impossible to find two events that are ever exactly alike, because the conditions from which they spring are never identical."

– Marc Bloch, French historian (1886 – 1944)

On the heels of last quarter's erratic market behavior, there has been a resurgence of skepticism regarding the fiscal health of the developed world. Though the first days of September trading struck a more optimistic note, most data continue to cast doubt on the sustainability of economic recovery. If the US and EU do, in fact, experience a prolonged slowdown or even contraction, how should that affect agricultural and soft commodity markets over the next six to nine months? A cursory review of past recessionary episodes – including the most recent in 2008 – suggests that a pullback in commodity prices would likely result. **However, we believe that a dogmatic focus on the past without regard for current context can lure investors toward misleading analyses, leaving them vulnerable if today's macro environment causes markets to deviate from what may seem well-established precedents.**

Given the recent onslaught of negative US data concerning housing, industrial production, unemployment, etc. the question "How might this time be different?" is key to Galtere's medium-term outlook on ags and softs. While we expect developed economies to enter a period of stagnated growth at best, we do not anticipate that commodity prices will tumble the way they did during the 2008/2009 financial crisis when a primarily demand-led rally ran aground. By and large, we believe that the agricultural sector should remain supported in the event of fiscal deterioration in the US and EU, and that price determination should follow a comparatively nuanced progression to which both demand and supply contribute in varying degrees.

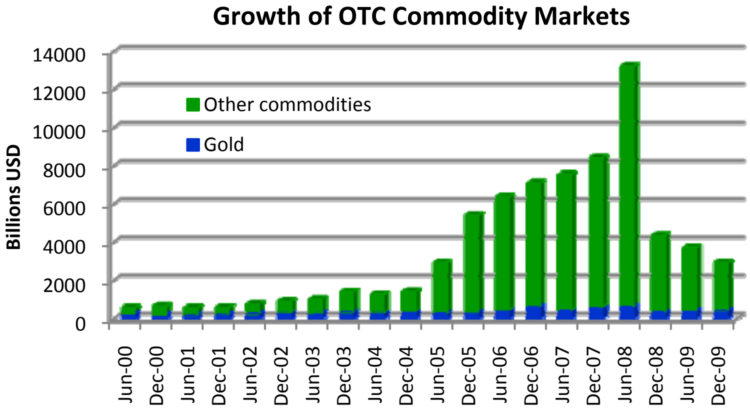
A comparison of the three central elements currently affecting commodities – market positioning, global demand inputs, and structural supply conditions – to those in existence two years ago suggests that history is not necessarily doomed to repeat itself. Broadly speaking, 2008's highly inflated prices in overcrowded ags and softs markets represented the culmination of a multi-year demand surge that coincided with peak production of many crops. How does that macro atmosphere differ from what we see today, and how might those divergences affect the medium-term outlook for agricultural commodities?

597 Fifth Avenue, 12th Floor • New York, NY 10017
212-598-1837 (tel) • 212-598-0778 (fax)

Positioning

While Barclays reports that investments in commodities recently rebounded to $300 billion, the OTC market is nowhere near its peak. Recent statistics published by the Bank for International Settlements show $2.9 trillion is currently invested in OTC commodities, which pales in comparison to the record $13.2 trillion in OTC commodity participation as of June 2008 (Figure 1). For several years before the crisis, an indiscriminate flow into commodities helped obfuscate fundamentals, and commodity prices rose nearly across the board without much regard for individual market drivers. Similarly, when numerous overleveraged investors sought liquidity in 2008, their exit from OTC instruments helped cause a vacuum that pulled these highly-correlated commodities down in sync. We believe that less-congested OTC flows should allow fundamentals to more freely influence markets, preventing them from becoming too highly correlated. This should leave commodities less susceptible to the same deleveraging effects seen in 2008.

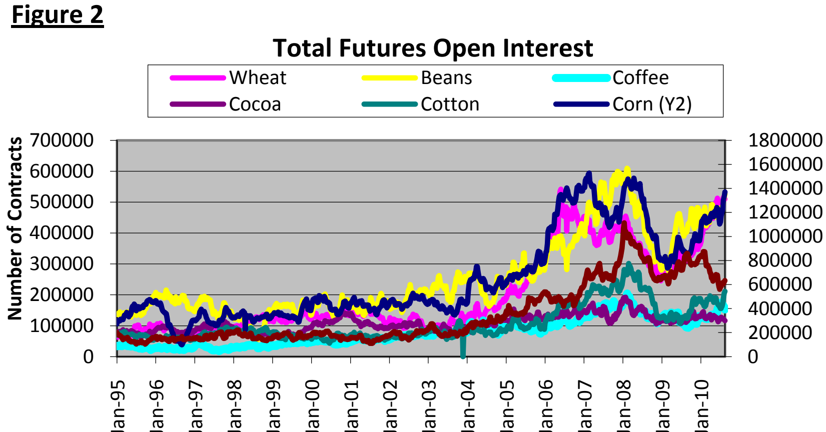
Figure 1



Source: Bank for International Settlements

Total open interest, meanwhile, has bounced back in all markets though still remains below peak levels, especially in the softs (Figure 2). For example, total open interest in sugar stands at just 56% of its record, and even the most saturated soft commodity market, coffee, stands below 75% of its all-time high. Grains markets have attracted more investment flows than soft commodities to date, resulting in higher total open interest levels that range from 85% to 93% of their peak. Notwithstanding this amplification of commodity investment and the increased volatility that it is likely to provoke, we remain constructive on agricultural markets in the medium-term. Balance sheets are for the most part much tighter than they were two years ago, suggesting that a slowdown or even a contraction in the US and EU should not eclipse the fundamentals of supply. In fact, we anticipate that certain commodities could face upward pricing pressure despite lackluster economic activity in developed nations.

Figure 2



Source: Bloomberg

Global Demand

Of the three main determinants behind commodity price discovery, we believe global demand bears the most similarity to the pre-2008/2009 landscape. In addition to growing appetite on the part of more institutionalized biofuel mandates, our bullish view on agriculturals over the next six to nine months is due largely to ongoing demand from emerging markets. As has been the case for nearly a decade, developing economies currently function as a major component of demand growth in ags and softs.

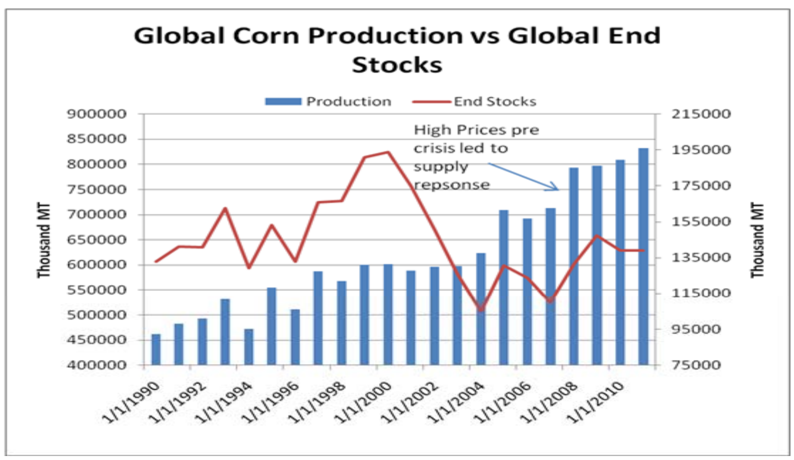
The increasing purchasing power and dietary upgrades of this emerging middle class showed few signs of structural reversal during the most recent crisis. In fact, demand continues to rise: the USDA expects global corn demand for the 2010/2011 crop year to reach a record 831 million metric tons (MT). According to industry sources, China's wheat and coarse grain demand has risen nearly 15% over the last decade, and this year, for the first time since the mid-1990s, they imported corn from the US. Grains demand from the Middle East and North Africa has risen 10% in the past five years, while global sugar demand for 2010/11 is expected to reach all-time highs of 170 million MT – an increase of close to 15% since 2005. Cotton demand is expected to rebound to near-record levels; since 2000, Indian cotton demand has risen by 54% during which time Chinese cotton demand has surged by 140%.

Although these demand trends have clearly been in place for years, we do not believe that another incident of fiscal downturn in the G3 would be a major concern for medium-term agricultural markets. First, the substantial and resilient EM demand growth detailed above is expected to continue its rise. Further, the continued tightening of supply in markets whose prices are generally well below their inflated pre-crisis levels indicates that US and EU demand need not be considered pivotal to how these markets will behave.

Supply Considerations

If current demand trends seem to embody a steady continuation of their pre-crisis narrative, current supply factors appear to construct an exaggerated retelling of pre-2008 balance sheet constraints. End stocks across numerous markets were being drawn down prior to 2008's liquidity crisis; however, the effects of increased demand for grains and soft commodities were mitigated in part by a vigorous supply response. This season, by contrast, acreage reduction and weather issues have caused supply disruptions in several markets that already face low end stocks (Figure 3). Underpinning the global ag supply story is the increasingly diminished acreage in major production regions. Total US grain planting this year is estimated at 318 million acres, which stands below the peak of 325 million prior to the financial crisis. In addition, arable land in China has decreased from 130 million hectares in 1996 to 121.7 million hectares in 2008 according to the National Bureau of Statistics. Private estimates based on satellite imagery currently report that arable land in China has already fallen below 120 million hectares and should continue to decline to around 117 million by 2015.

Figure 3



Source: USDA

This season, multiple weather disruptions threaten to reduce yields in several markets. As recent headlines have indicated, wheat production is expected to fall by 35-40 million MT year-over-year; yield estimates have been slashed due to droughts in the Former Soviet Union, as well as extremely wet conditions in Canada. In addition to wheat, concerns over corn yields have begun to surface. Despite ideal weather throughout much of the growing season, multiple accounts of early harvests in the US corn belt suggest that final production numbers may disappoint. If the harvest continues to underperform, US corn yields could fall to a national average of 161-162 bu/ac. This would result in end stocks dropping below 1 billion bushels, and a reduction of the stocks-to-use ratio to a near-critical low of 8%, compared to a five-year average of 17.4%. Among the soft commodities, global cotton acreage is down over 9% from just five years ago due to competition from other crops such as soybeans. Meanwhile, production losses within major coffee producers, including Colombia and Vietnam, have resulted in a reduction of certified inventories. Adverse weather has plagued Colombia's crop this year, after two seasons of underperforming the average yield of 12 million bags by roughly 25-30%.

In addition to supporting a medium-term bullish outlook for commodities, the current interaction of extremely tight supplies with continued demand growth has led to some dramatic moves along the curves of several markets. Prior to 2008, price discovery was primarily demand-driven, with end users concerned less with nearby supply than they were with securing forward contracts. This sent bull markets across commodities into contango as longer-dated futures traded at a premium to spot. Now, with supply more prominent as a price determinant, we expect that an increasing number of commodities will see their curves narrow. This should lead to backwardation as securing nearby supply becomes more compelling for market participants. We have already seen this happen in cotton, sugar, NY coffee, and most notably corn, where Dec10 vs. Dec11 has moved from contango of -40 cents to backwardation of over +15 cents (Figure 4). If we begin to see this trend reverse and curves move steadily into deep contango, we will view that as an indication that either demand has become slack or supply more abundant, and will reevaluate as necessary. From this vantage point, however, we believe that the next six to nine months hold the potential for significant weather disruptions at a time when end stocks are critically low and demand for agriculturals remains unabated.

<u>Figure 4</u>

Dec10 / Dec11 Corn Spread

Source: Bloomberg

* * *

It seems natural that mounting concerns over the fiscal stability of the US and EU could lead to speculation that commodities might reprise their 2008 performance in the event of another slowdown. Yet, in the specific case of agricultural and soft commodities over the next six to nine months, we believe that a comparison of current conditions versus circumstances two years ago paints a more constructive picture than one might otherwise assume. Demand for many agricultural commodities is back near record levels as emerging middle class purchasing power increases and sovereign entities seek access to natural resources and arable land. This time, however, supply has not kept pace as before. In addition to a drop in planted acreage, global production has already been hampered by both drought and heavy rains, and La Niña's approach may bring further weather disruptions to South America. There is, of course, the potential for volatility as more investors participate in commodities. Overall, we anticipate that the intersection of demand growth and supply constraints will present dynamic medium-term opportunities across agricultural commodities – and that the key to navigating these markets will be an awareness of how previous patterns may manifest differently in today's environment.

Renee Haugerud, CIO

September 2010