

Monthly Review

22nd February 2010

- **The Eurozone faces an uncertain future**
- **US growth prospects are hampered by deficit concerns**
- **A long economic restructuring awaits the U.K**
- **Fundamental do not support a grain bull market at present**
- **Ivorian political unrest unsettle Cocoa prices**
- **Low sugar stocks underpins high prices for the moment**

Macro Summary

Monetary authorities successfully rescued the global wholesale money market in the second half of 2008. The massive injection of cash enabled most economies to return to a semblance of growth by the end of 2009. With the exception of China, however growth output has been notably sub-par.

Significant deleveraging still lies ahead in an environment dominated not by lack of liquidity, but by the solvency of states, corporations, households and individuals. A long economic upswing, beginning soon after 1945 and ending in the decade just finished, was extended beyond historic precedent by massive credit creation. For the credit cycle to adjust to its long-term norm, much of this decade will be required in order to normalise economic conditions. It will end when the credit cycle returns to that of the long-term nominal gross national production expansion path. Quite simply the credit bubble, now in the first phase of deflation will return to its long-term path by one of two ways. Either widespread default, ranging from sovereign through to individual takes place with associated massive asset price deflation, or government induced inflation occurs which allows nominal gross domestic product to adjust upwards whilst, at the same time, inflating debts away. From all current evidence it has to be concluded that the deflationary option, intended or otherwise, is the path upon which we are embarking upon. It is against this backdrop that highly indebted states, mostly in the West are now being forced to confront decades of economic mismanagement. Indeed, it is correct to say that the last bubble to burst as the long post war economic cycle ends, is that of the bloated and highly indebted first world nation state. The bond market vigilantes, long feared by policy makers and Central banks are now at large, pronouncing judgment via repricing debt. At the same time, the main rating agencies, anxious to make up for over rating most issuance in the boom period are now imposing much stricter assessments on all classes of bonds. Current events in Europe best illustrate the enormity of the debt issue faced by the West. The age old laws of money have dramatically surfaced above the politics of the Euro zone. If income does not match expenditure and borrowing to cover the difference is not possible, then default is the result. A battle is currently underway within the European Central Bank regarding massive loan extension not only to Greece, but also Spain, Portugal, Ireland and Italy, has opened up the scale of the Sovereign debt problem. As the funds are removed from the banks in these countries, they will call upon the ECB for the re-financing. There is growing German resistance to providing the necessary funds, and it is correct to think the previously unthinkable that a break up of Euro-member countries is inevitable. A hard core of Euro countries, with Germany dominant, will then emerge with France still a member and possibly Italy. The weakest members would resume their own currencies accompanied by a large devaluation of some 40% against the hardened Euro. A replay of the 1992 expulsion of the British pound from EMU is a realistic prediction for the events likely to take place in the months ahead.

It is not just the Euro zone that faces severe financial problems. The U.S, U.K and Japan have unsustainable spending programs. The longer the current situation exists whereby economies deeply wounded by excessive credit expansion prolong such a unrealistic condition, by further expansion of credit, coupled with unrealistic high asset valuation, the more potentially catastrophic the final crisis will be. What is interesting at present regarding market price behaviour is that market price movement takes place against a backdrop of seeming normality. We are effectively faced with an ongoing cycle whereby markets inevitably give a picture of normality for a short period which is then punctuated by bursts at the macro level of intense volatility triggered by an crisis which cannot be contained run by the monetary authorities, such as the Bear Stearns/ Lehman/ AIG crisis and the current Euro zone problem. We are only a part way into a period of deleveraging and credit collapse. The longer the political elite fail to address the main problem of national government finances, the more likely the end game will be worse than anything experienced to date.

Market Trends

The relative optimism that was seen in global markets in early January soon ended as the reality of global debt problem surfaced. Problems long ignored have been exposed as Greece's seemingly intractable deficit financing problems made the headlines. European credit markets are now flashing the most serious warning signs for a year as yields rise on many non government issues and equity flotations are postponed. Chinese credit tightening and default risks in Greece and Dubai have all but halted a spell of record issuance. The Markit i Traxx, Crossover index which measures yields of low grade debt has risen by some 130 basis points since mid January to 514, and the main index of investment grade bonds has jumped by a third to 93. The index is a lead indicator and is a warning signal for problems ahead. Borrowing costs are rising and debt issuance is being cancelled, whether it be sovereign, corporate or household and will trigger a renewed global contraction by 2011. The huge demand for funds by most governments are quite simply crowding out commercial and household borrowers. It will only be when the bloated Western governments which constitutes the biggest bubble of all, dramatically cuts spending, that a new and sustainable economic recovery can take place. The sudden sharp slowdown in corporate bond issuance is disturbing since companies have been relying on capital markets to raise money as an alternative to banks loans. The ECB has recently stated that 42% of small businesses in the Euro zone reported worsening credit conditions in the second half of last year, despite the emergency stimulus of central banks.

As uncertainty increases, the US dollar as the global reserve unit of account, inevitably is seen as a refuge. The chronic position of Federal and State budgets are put to one side by global investors anxious to place money in the most liquid and seemingly safe market in the world. Last month we were bullish of the U.S dollar giving an upside targets of 79.5 basis the dollar index. The move to date has exceeded our objective, reaching 81 last week. Given our bearish approach to most global markets this year, as they buckle in the face of major credit problems, the U.S currency could very well trade higher still and approach levels previously traded in the first quarter of last year when a high of 89.62 was recorded.



To determine market price direction at present, three important points stand out. Firstly, whilst the discount rates hike to 0.75% from 0.5% late last week signalled the end of the crisis confronting the money markets, it certainly does not signal an end of the economic crisis. To quote Fed Chairman Bernanke in his testimony last Wednesday when describing the policy of “normalising” the Federal Reserve’s lending facilities in light of the improving conditions in financial markets. “They are not expected to lead to tighter financial conditions for households and business and should not be interpreted as signalling a change in the outlook for monetary policy.” As Kansas City Fed Chairman Hoenig stated, that fiscal policy is an unsustainable course with U.S debt threatening the Central banks objectives. He fears the issue of private indebtedness will worsen political pressure on the Fed. The housing market remains in a fragile state with one in five mortgages under water. House prices have now fallen for twelve consecutive quarters. Yale University economist Robert Shiller has recently stated that he expected a further fall in prices, which have already fallen 30% from their 2006 peak. If a renewed fall in house prices does occur it will be the trigger for a renewed contraction for the overall economy by 2011. It should be noted that property prices fell consecutively for fifteen years from 1990 in Japan, and Professor Shiller speculates that the U.S may repeat Japan’s experience. Historically following the collapse of major credit bubbles, it can take some twenty years for an economy to rebalance in order to grow once again in a sustainable manner.

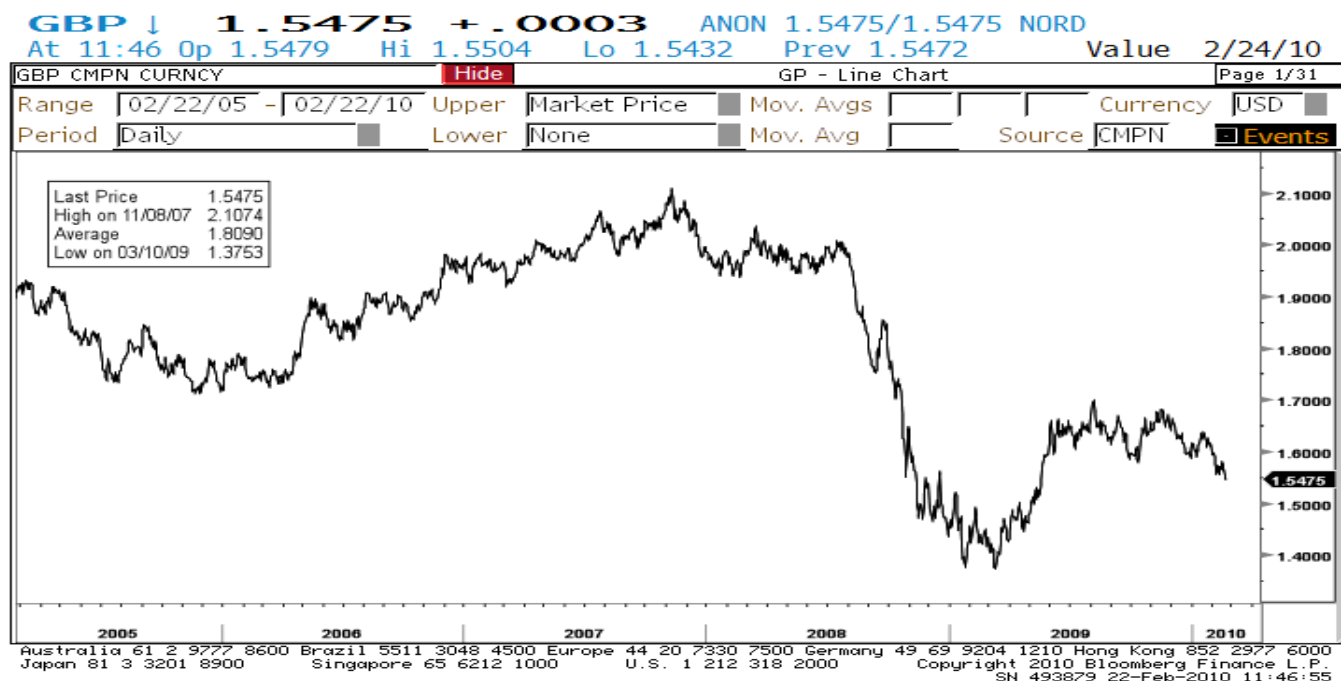
The second key point to factor into market pricing at present is the political one. Because job growth is seen as being essential leading up to the 2012 U.S presidential election. “America first”, policies will be increasingly seen regarding many parts of the economy. Protectionist measures are being seen against Chinese imports for example and against Japanese cars. Pressure by way of a changed tax structure will be placed on U.S companies to move whenever possible production back to America and import substitution is the name of the game. A third point is concerns geopolitics with growing uncertainty in Euro land, Chinese overheating on the one hand, and growing problems in Japan regarding the future of its unbalanced economy. The U.S can be expected to defend its superpower status, however economically wounded and the attraction of U.S assets for the immediate terms sees assured. Longer term however the frightening size of the deficit has to be addressed. The Obama budget takes the publicly held debt to 73% and the gross debt in 103% of GDP by 2015. Such a vast debt implies immense future tax increases. Balancing the 2015 budget for example would require a 43% increase in every Americans’ income tax that year! It is hard to imagine a worse deterrent to economic growth.

We remain dollar positive and remain buyers of gold on as the outlook for all paper currency remains uncertain. In addition, whilst the bond yield curve looks to steepen even more and the long end look vulnerable, a full-blown bear market is not likely whilst a disinflation environment exists. The five to ten year sector will be supported on any pull back and should be bought.



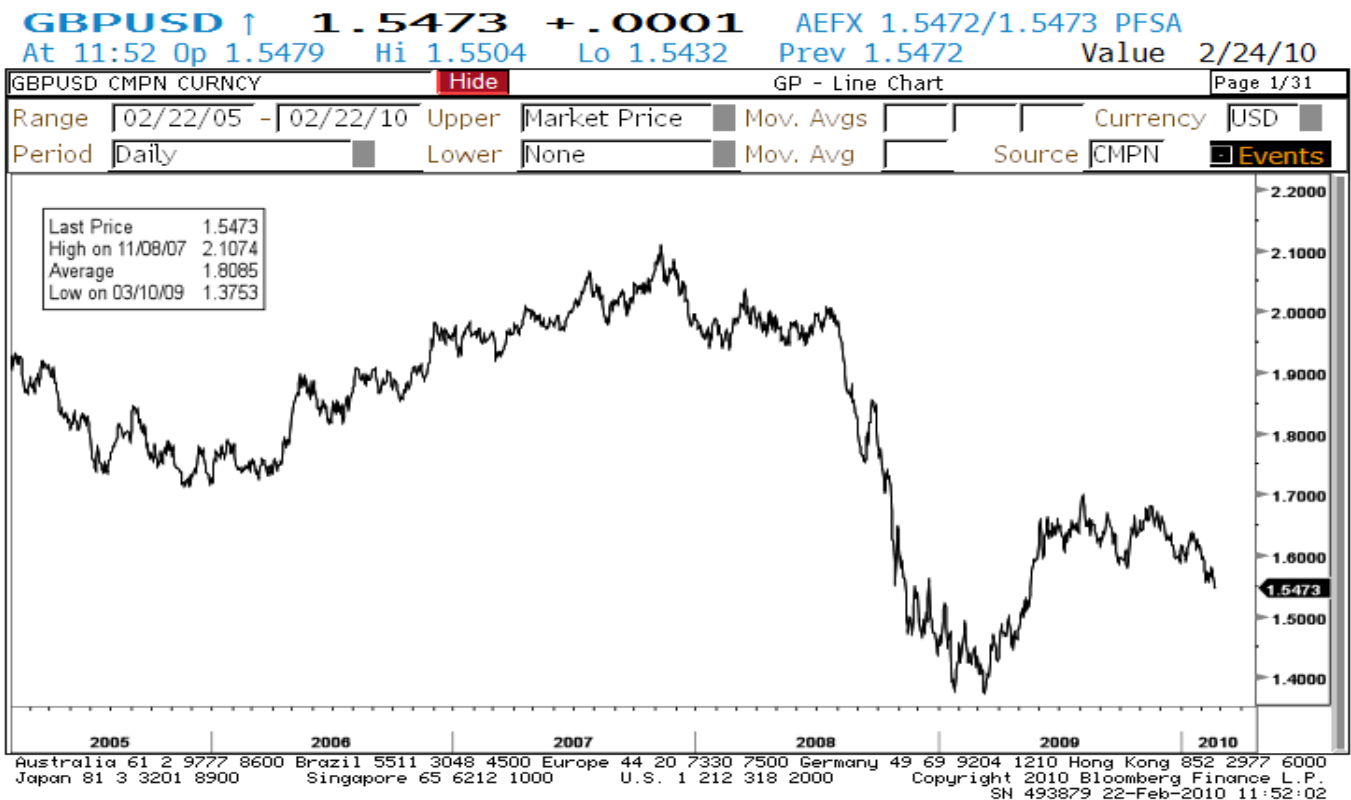
UK Update

The United Kingdom economy has barely emerged from its deepest recession since the Second World War. A measure of stagflation exists for the moment with recent food and fuel price increases causing input costs to rise. Transmission of inflation to wage growth however is simply not happening and consequently higher food and energy prices should be seen as an indirect tax on income. With wage compensation all but static and in real terms falling outside the public sector living standards are eroding and we expect this to continue well into the middle of this decade. Business investment has been significantly cut and unemployment is rising. The headline claimant count is the highest since 1997 and the International Labour Organisation jobless security benefit system is such that more money can be claimed via this compensation system rather than registering as unemployment will continue to rise far at least three years as a significant fiscal squeeze is about to be imposed on the economy. Consequently the public sector which has grown significantly at the expense of the private sector since 1997 is cut back. In addition we expect a continued contraction in the sector as a permanent shift in consumer behaviour is seen. 10% of shops have closed since 2008 and this trend has a lot further to go. Discretionary behaviour spending will shrink year on year in the decade ahead. It has to be remembered that the baby-boomer generation born between 1954 and 1970 is retiring at an increasing rate. With increased longevity, more and more savings from the wealth net income group will be devoted to the necessities of retirement. The post baby-boomer generation, will have much less disposable income and will be forced to divert much more income to savings. It is small wonder that the high street and travel industry is embanking on a major change. We expect the UK economy to remain in a very low growth environment for some three or four years. The transition to a radically different economy will take a decade at the very least.



The Sterling index chart best illustrates one of the few positive aspects faced by the UK economy at present. A devaluation followed of some 20% has occurred since 2007 by the pound against a basket of other currencies. A larger devaluation followed Britain's expulsion from the E.M.U in 1992 and it had a remarkable impact on the British economy as it led to a rapid export led economic upswing. Unfortunately this time the global economy apart from China is not in good economic health and even it will experience much more difficult times within two years as monetary tightening triggers an economic downturn, a downturn made worse by the American led protectionist measures already underway. We expect further weakness for the pound in the year ahead. Versus the dollar we do not rule out a move to the lows seen in 2001 and 2008 when cable traded below 1.40.

Interest rates will stay at 0.5% for considerable time. The cost of real money is rising sharply. Loans of all descriptions are now costly and will rise further and as consequence the bank base rate is almost irrelevant. The 3.5% premium over base rate for mortgage related borrowing is at an all time record for example; Credit card interest rates are rising as are all loans connected with the highly indebted consumer sector with solvency the main issue for lender. Banks are reluctant lenders and are being forced by regulators to increase their capital at the expense of lending. In effect money is scarce in commodity term and consequently costs more. The gilt market yield curve is at a record degree of steepness as supply gradually forces long rates higher. The ten year benchmark now yields 4.17% and our 4.6% target remains valid. We do not foresee a major bear market however as on a two year time horizon we cannot rule out deflation in the U.K. Consequently gilt yields may even fall from the 4.6% level in spite of the considerable issuance which lies ahead.



Energy

Last year it was correct to adopt a bullish posture to the energy complex. \$75 per barrel was cited by key OPEC members as being a fair value for oil prices. Last month, we expressed a degree of caution regarding the future trend for prices because, firstly, increased production is likely to be seen from OPEC members as this year progresses, and secondly, we remain bearish for global growth in the year ahead. Accordingly we feel that the International Energy Agency's recent forecast that global demand would grow by 1.6 million barrels per day to average 86.5 million bpd overstates the demand picture. At the same time Opec members are expected to increase supply to the market by some 1.6million bpd by mid year. Such in the need for hard cash in a world beset by tight credit that commodity exporters cannot afford to limit production, as they seek to increase income.

The importance of emerging markets in the determination of commodity prices is a given fact. It reflects the shifting centre of gravity in global manufacturing. Oil demand has almost certainly peaked in the developed world and accordingly, commentators must closely follow demand and associated economic policy in China, India and Brazil. China last year injected the equivalent of 30% of yearly G.P.P into its economy. This, not surprisingly resulted in a rapid return to growth from what, in real terms had been a negative final quarter in 2008. Commodity markets rallied in response to the large capital injection. What is now underway in China in a tightening of policy to dampen forces and address the markedly positive output gap. Commodity prices will in the months ahead by Chinese monetary policy and accordingly, we remain negative for the price trend of most Industrial commodities this year, as Chinas growth trends lower.

For the immediate future, we see oil prices trading in a sideways range between \$68-\$82 per barrel. Only military action in respect of Iran would cause oil prices to spike above the top of the range.



Grain & Oilseed Review

In the interim before the northern hemisphere spring planting season gets underway when traders will begin to focus on spring weather conditions, CBOT grain & oilseed prices seem likely to be influenced mostly by the direction of the dollar and the arrival of South American new crop supplies.



Corn

There was a decline in both the 09/10 US & global carryout stocks of corn in the February USDA Supply & Demand report that provided some fundamental reasoning to the recent recovery in corn prices from their steep decline since early January. However with the dollar expected to continue to strengthen amidst continuing concerns over the eurozone debt crisis, the corn price recovery may well have run its course already with prices set to return to the downside and to a subsequent test of the early Feb lows. At some point however the focus will turn again toward new crop acreage and then to the early season planting conditions. The next stage on this seasonal roadmap will be the analysts estimates for 2010 corn acreage that precede and are followed by the actual USDA Prospective Plantings Report on the 31st of March.. Weather should become a much more sensitive market issue from the middle of March onwards, with traders paying particular interest to the 10 day outlooks from that time. This of course is still some way off in the Calendar, which is why corn prices are still being pushed around by the outside markets and in particular the currency market. It is difficult to believe that the rally in corn prices can extend much further than current levels at just under \$3.70, but if crude, gold and the currencies continue to rally, then its conceivable that nearby corn prices could attempt to fill a chart gap beginning at \$3.855. Given the size of South American crops and the likely continuing strength in the dollar however, it seems more probable that prices will eventually retreat to a retest of the February lows at just under \$3.50, but the battle is on!



Soybeans

At the time of writing this report the soybean market is 7 trading days into a recovery after bouncing off the psychologically important \$9.00 price level. The recovery in US equity prices followed by a tighter-than-expected US carryout on the February Supply & Demand report and the reluctance by the US farmer to sell beans to satisfy a huge vessel line-up to China, are the principle reasons for the strength. However looking ahead with China currently on its New Year holiday and the dollar continuing to strengthen, there are fears that the switch from US origin beans to South American beans will become significant enough to ease the tightness in US cash premiums. Therefore upon China's return from its New Year celebrations traders will quickly seek to determine their appetite for US soybeans and or their move to South American origin. Technically although we could yet see the market rally further, perhaps to \$9.80 in the front month contract, it appears more likely that prices will eventually re-test the \$9.00 level over the coming weeks as the weight of South American harvesting and supplies takes its toll on prices. That said however, the \$9 level should become a tough area of support to break through, as indeed the above chart suggests.



Wheat

The fundamentals certainly don't appear to get much better for **wheat** prices, with the latest USDA Supply & Demand report reflecting yet another, albeit small, increase in both global and US carryout stocks of wheat. With a strengthening dollar there isn't much hope of exports making a serious dent in those stocks over the foreseeable future. Thus the wheat bulls are likely to have to wait until northern hemisphere wheat crops break dormancy before any weather related excitement can stimulate prices. At present, crops have mostly good snow cover in the northern hemisphere and so there are no immediate concerns for crops at this time. Consequentially it seems more likely that the recent recovery in wheat prices is nearer its top than its beginning, with prices probably establishing a possible trading range that could extend from \$4.70 on the downside to \$5.10 on the upside. Indeed the market may well become range bound as it awaits the news on the spring growing conditions along with the further confirmation of the USDA's smaller acreage figure when it releases the March 31st Prospective Plantings Report. Wheat prices may also be more vulnerable to the outside markets at this time, with gold, crude and the dollar carrying significant influence in an otherwise quiet period for wheat fundamentals.

Cocoa Summary

Cocoa has continued to remain steady at around 32 year highs either side of the New Year. This matches a similar double high in the New York market.

Subsequent to these highs the market has given back ground in a spell of long liquidation, profit taking by Funds. The principle rationale of the decline appears to be with a combined range of factors as opposed to any single issue. An upside assist was lacking with flat Q4 US and European grinds, reasonable rains in West Africa with a background of a benign Hamattan to date. In addition, the Ivorian cocoa arrivals had not fallen off a cliff but have certainly tapered in seasonal fashion. Technical considerations with a large speculative Long position in both London and New York. External macro issues such softer indexes, weaker demand outlooks for the economies have weighed. New York's retreat from the highs has been further exasperated by a firmer Dollar and Mar10 liquidation and roll forward of positions.

The recent sharp decline has been tempered with a consolidative bounce led with some profit taking into the decline and some renewed Industrial price fixation. This has been volatile at times and has had a strong assist with the spectre of Ivorian political unrest returning. Political tensions were rising ahead of slated elections in March, however, this is now likely to be impossible with the unity government being dissolved and the electoral commission being sacked. Opposition parties have already called for a Presidential resignation and the likelihood of re-assembling a credible government and Electoral commission looks fraught. Demonstrations and tear gassing have already occurred and a spiral of civil disorder looks plausible. Although the likelihood of immediate and significant disruption and delay to Cocoa would appear low, the political uncertainties are likely to rumble on for some time.

Daily QLCCc2

31/07/2009 - 24/02/2010 (LON)

15/02/2010, 2,274, 2,302, 2,271, 2,284

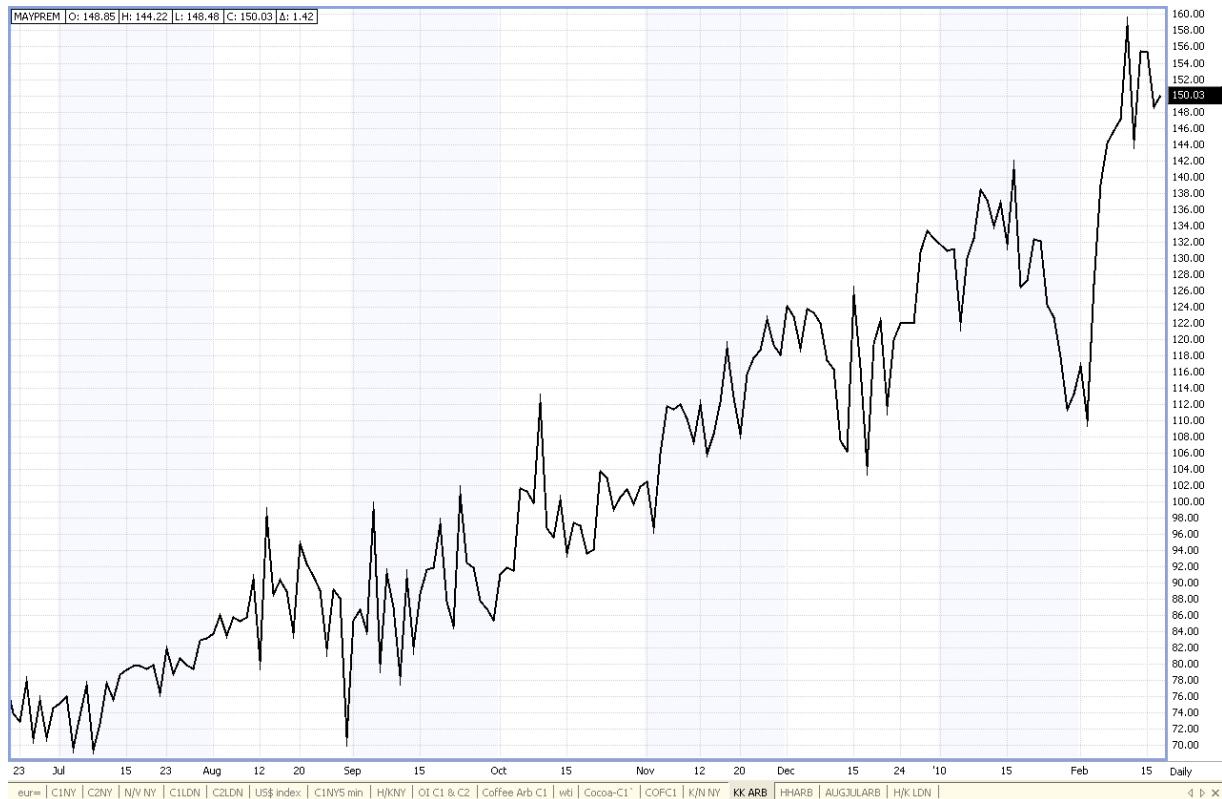


London 2nd month continuation

Sugar

The market started the month by touching record highs of 30.40 cents/lb, but despite hitting the highs the gains could not be sustained and the weakening macro picture combined with a couple of well publicised tenders being cancelled initially lead to light profit taking, which then lead into larger liquidation as the market plunged to levels not seen since the middle of December last year. While the raw sugar market collapsed over the week, relatively speaking the white sugar market held up fairly well as the nearby deficit is still greatest for white sugar. The big talking point of the month was the reversal in the March/May spread in London as chatter started to emerge that Mexico had awarded import licences for around 150,000 tons of white sugar, and suddenly the problem sugars that had been overhanging the market had a home and the spread snapped back from \$5 discount to a \$28/ton premium. It was not just the spread that saw dramatic moves, the May white sugar premium went from \$110/ton premium to a \$144 by the end of the month. Indeed, some believe even at these lofty levels the white sugar premiums are good value as there is simply is not enough refinery capacity in place at the moment; so the premiums will no longer reflect the cost of refining and massive financial incentives will be needed to tease out more white sugar.

White sugar premium May 2010 London V's May 2010 New York



Elsewhere, World 2009-10 sugar production is revised down to 153.9 million metric tons raw value, as output from the Americas and Asian countries is below expectations, said F.O. Licht said during the month, which is down 2.9 million tons from their October estimate. While the bulls drums continued to be beaten in Dubai at the sugar conference, on the fundamental front Pakistan failed to agree terms on the 150,000 tons of white sugar it tendered for over the weekend, one unknown company submitting a bid significantly lower than others from more recognized sugar firms. Ultimately, the failure by Pakistan not to agree anything at its tender did not surprise many participants and perhaps sensibly it has postponed its tender for the weekend just gone until this week, but early indications are that they have once again passed on it. Also in the subcontinent, domestic prices in India came under pressure as the government allowed mills in Uttar Pradesh to sell around 650,000 tons of imported sugar that had been stuck in port. Domestic prices also came under pressure from a government ruling that stipulates that mills must sell quota sugar on a weekly basis, instead of monthly, as well as the large bulk buyers standing back concerned that the government may force them to only purchase sugar that is imported from over-seas. The rulings meant that domestic prices are under pressure, but it is unlikely to last once the harvest draws to an end; so far at least 28 of the 128 mill are now closed for this season. With everyone now back from Dubai people are looking to find out what next is in store. Will further fund liquidation be met by end users keen to snap up any weakness they can, or will buyers sensing some weakness for the first time in month lower their ideas? There is a danger that the market starts to focus upon the more balanced supply and demand situation later in the year and further gains could be limited. While there have been plenty of headlines recently “reminding” the market of this upcoming surplus, it is worth remembering that after two years of severe deficits stocks are low so any small surplus will easily be swallowed up, and it would not be until the year after (assuming crops recover) that these stock levels will recover. Therefore the market still remains very vulnerable to weather concerns and is still yet to solve the problem of the huge deficit in the first half of this year.

New York May 2010 Daily Raw Sugar



Coffee

Prices have weakened over the past month. This is more a consequence of the macro picture than any significant shift in the fundamental outlook. Indeed, many physical traders will point to a short term tightness in quality washed arabica for a reason why prices should be significantly higher than their current levels. At one point the New York market was around 10 % lower in value while London saw values drop by nearly 6.5 % although prices have recovered slightly over the past few days. One upshot of the drop has been the narrowing of the arbitrage by nearly 10 cents which we did suggest was too wide in our last report. We would expect it to narrow further in the coming months. A recent Reuters coffee poll had most participants expecting NY prices to improve by the end of the first quarter. Their reasoning is that certified stocks have now dropped below 3 million bags their lowest level since February 2003 suggesting the much talked about tightness in washed arabica is coming to fruition with production being hit in Colombia, Mexico and Central America due to dry weather. However, prices have not responded. As mentioned above this is probably due mostly to the firming US dollar and a reduction of risk by the funds. The fact that Brazil's 2009 exports were a record at 30.3 million bags could be seen as a fundamental reason as could be the prospects for a truly huge 2010/11 Brazilian crop. While few dispute the crop will be large there has been worries over the quality due to the uneven flowering which was feared would lead to uneven ripening. Latest report suggest that the maturing of the cherries may have evened out so, as long as the harvest period remains dry then not only will it be a huge crop but also of reasonable quality. With crop prospects in Colombia and Central America looking better for their next crop a large surplus of arabica is likely by the second half of this year. Current supplies of robusta are more than adequate. With another large Vietnamese crop likely and no reported problems elsewhere a surplus will also be seen in robusta. Therefore, we expect prices to fall further this year with a target of around 110.00 cents in New York and \$1000 in London. The US dollar will continue to influence short term prices but, we believe, the bearish fundamental picture will dictate prices longer term.

Weekly KCc1

25/02/2007 - 21/03/2010 (NYC)

21/02/2010, 133.15, 133.75, 133.05, 133.60



Freight Review

Looking at the freight markets in December and January, we saw emergency coal buying by Europe and Asia in reaction to an extreme cold spell, which supported the market whereas iron ore was pretty steady. Interestingly enough a mixture of new build vessels hitting the water and the aforementioned coal activity made the past two months rather volatile, attracting financials into the freight derivatives market again, which increased volumes substantially. Currently, Chinese New Year is taking its toll with markets looking for direction and guidance, but with an early grain season ahead of us, and iron ore benchmark price negotiations making progress, volatility is likely to remain and pull volume back into the market in the course of February. Furthermore, we increasingly see financial institutions and asset managers set up hybrid shipping funds, buying distressed assets and trading both physical and financial volatility that clearly increases liquidity and allows for exploring trading opportunities.



C4TC and P4TC

(Spot and Forward Curves as per February 15th 2010)

Product tankers showed a marked recovery over Christmas that was a combination of both WorldScale adjustment and a pick up in demand. It seems as if restocking in Europe and UK power plants switching from coal to oil was the main reason for support. Vegoils are holding steady with better than expected palmoil and soybean oil volumes in January.



TC2_37

(Spot and Forward Curves as per February 15th 2010)