

Monthly Review

6th August 2009

- **US unemployment imperils economic recovery**
- **UK Quantitative ease fails to increase Bank lending**
- **US Dollar weakness triggers a new commodity upswing**
- **Coffee and sugar prices to trade higher**
- **Energy Prices to stay firm**
- **Grain Prices confirm a base and may trade higher**

US Markets

It is highly possible that the U.S economy emerged from its worst recession since the 1930's at the end of the last quarter. The equity market rally which began in March has pre-empted the economic upswing. The extent of the business investment decline witnessed since the peak in 2006/2007 has been quite spectacular. Residential investment which peaked at over 6% of GDP in Q106 was down 55% by Q209. Investment in transportation equipment fell 60% from its Q406 peak. Industrial equipment spending was down 24% and I.T spending fell 13%. Only government spending and tax rebates have stopped the economic contraction from being worse than it has become.

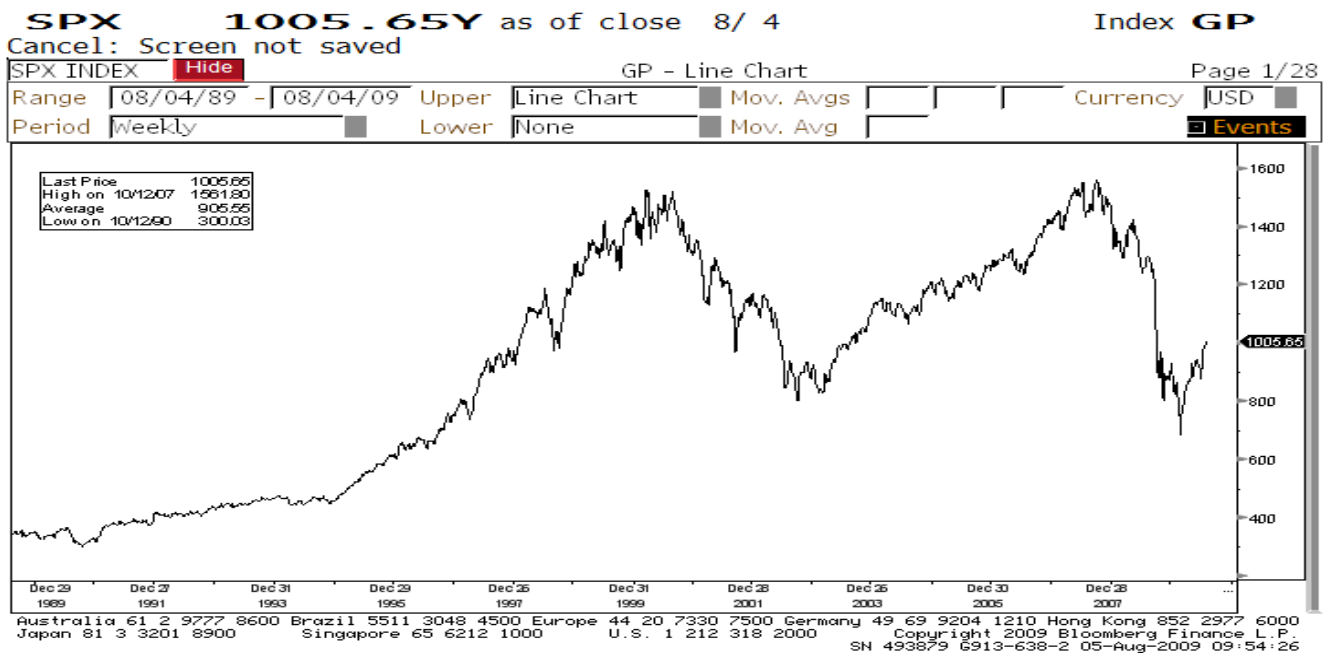
Looking ahead, in a period of cautious optimism it is vitally important to focus on the economic facts and forecast accordingly. The Fed's latest official review of the economy found in the "Beige" book reports the following. "Economic decline had moderated, lending was either stable or weaker, a modest manufacturing recovery was likely in six to twelve months, retail sales were sluggish, commercial real estate had weakened in most regions, labour markets were extremely soft and consumer spending was below the level of a year ago in most regions."

The Fed is in effect, reporting a far from optimistic picture of an economy based on data picked up some six weeks ago. By far the most worrying part of the economy concerns the employment situation. Our last report noted the fact that when the so-called U-6 tally is added to the normal monthly non-farm unemployment that factors in people who have given up looking for a job and work part time, the true rate is 16.4% or 25 million people unemployed. Cumulative job losses over the last six months have been greater than for any other half-year period since 1945, which includes the military demobilisation after the war. Job losses are now equal to the jobs gained in the previous nine years. The situation will continue to worsen well into next year and any economic recovery is likely to be a non-job creating event. Businesses will simply increase hours for existing workers. The average work week for normal employees is the lowest for 45 years, when data was first recorded. Factories are at present operating at just 65% of their capacity.

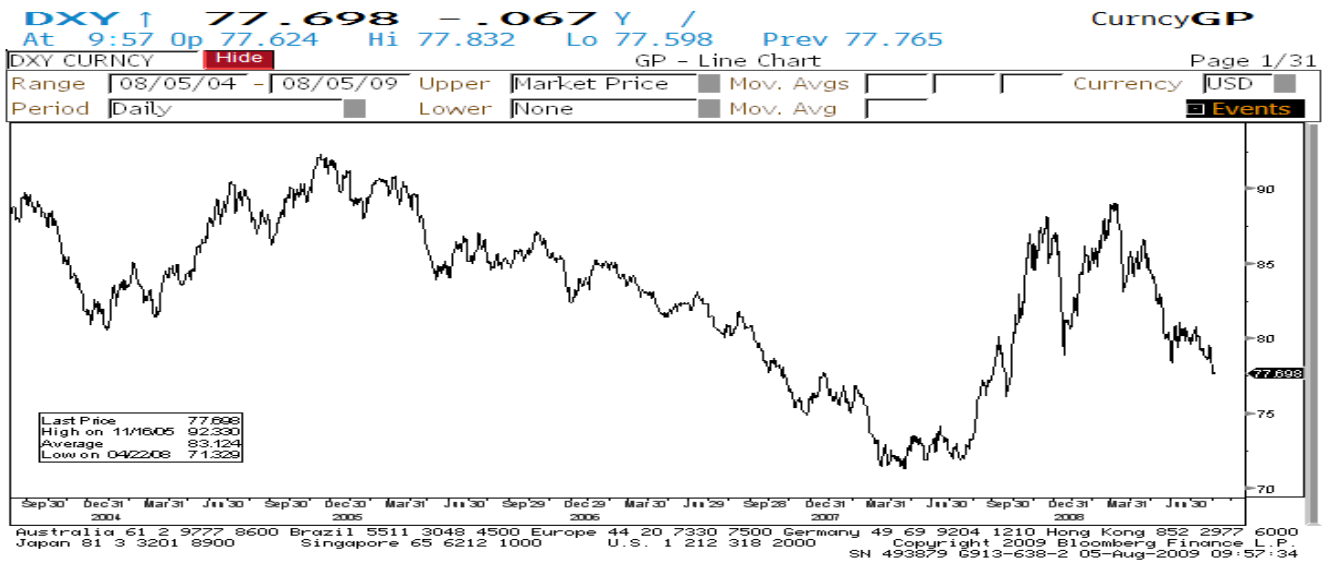
A worsening unemployment situation comes at a time of massive government stimulus. The Recovery Act was a single piece of legislation, which included thousands of funding schemes for a large number of projects and it appears that many such schemes are not being implemented quickly. In addition, funds allocated for Medicare, tax cuts, new benefits for the poor and unemployed do not add new jobs. Furthermore, most state and local government, some 15% of the economy are experiencing their worst contraction since 1945.

Households are rapidly acquiring the saving habit, as existing large debt obligations are paid off. The savings rate has risen from 0% after tax income in 2007 to over 7% at present, a figure which will move towards 12-15% within the next three or four years. The consumer sector, some 70% of the economy will undergo a profound change, and imports will fall accordingly. The trade deficit will most likely disappear within three years. This major structural change taking place within the U.S economy will result in very sluggish growth for a long period. It is our strong belief that the behaviour of the baby boomer generation has been crucial to the understanding of the post 1945 economy. Initially in the period post the Second World War; spending was based largely on accumulated savings that grew from the consequence of the last depression. When such savings largely disappeared by the mid 1970's a borrowing culture based on an exponential extension of credit rapidly developed. It is this credit cycle which imploded so spectacularly after 2007, coming to grief on the massive provision to millions of people for house purchasing. Many of whom were ill equipped to repay loans if just a small increase in interest rates took place. What lies ahead is long a period of household balance sheet adjustments, a period likely to last a good decade at the very least.

There will be occasional phases of economic activity as business inventories are re stocked. They will be a series of one-time events and will not deliver a sustained economic upswing. Business is the second largest borrower with debts of \$11 trillion (household debts total \$14 trillion). Business will not take more debt and most corporations are refinancing long-term debt and paying off short-term debt this year. Only the Federal government is accumulating debt in its attempt to stop further economic collapse. When the private sector again increases debt, interest rates will increase significantly unless the U.S government reduces its borrowing. A behind the scenes battle is currently underway regarding the issue of market to market valuation standards. In the early part of the economic crisis the Financial Accounting standards board largely suspended market to market. Thereby allowing in effect, an unrealistic value of many financial firms' assets, the implications of a return to normal accounting standards could have a calamitous impact on the equity market. The Casey Daily Dispatch has highlighted this recently and concludes that the issue has largely gone unreported. We await the outcome with a great deal of interest. It is possible that the credit rating agencies could do the job of "normalising" valuations by undertaking a wholesale re-rating of many institutions, if all too obviously incorrectly rated between 2000-2007. To quote the Casey report, the Fitch rating agency recently reviewed were those with the highest levels of debt in the S+P 1500. They represent approximately 75% of the total debt of S+P 1500 companies. The companies reviewed had a total amount of derivative position in excess of \$296 trillion with a net fair value in excess of \$240 billion. Whatever happens, it is correct to say that a long period of financial restructuring lies ahead and much more conservative, regulated world lies ahead.

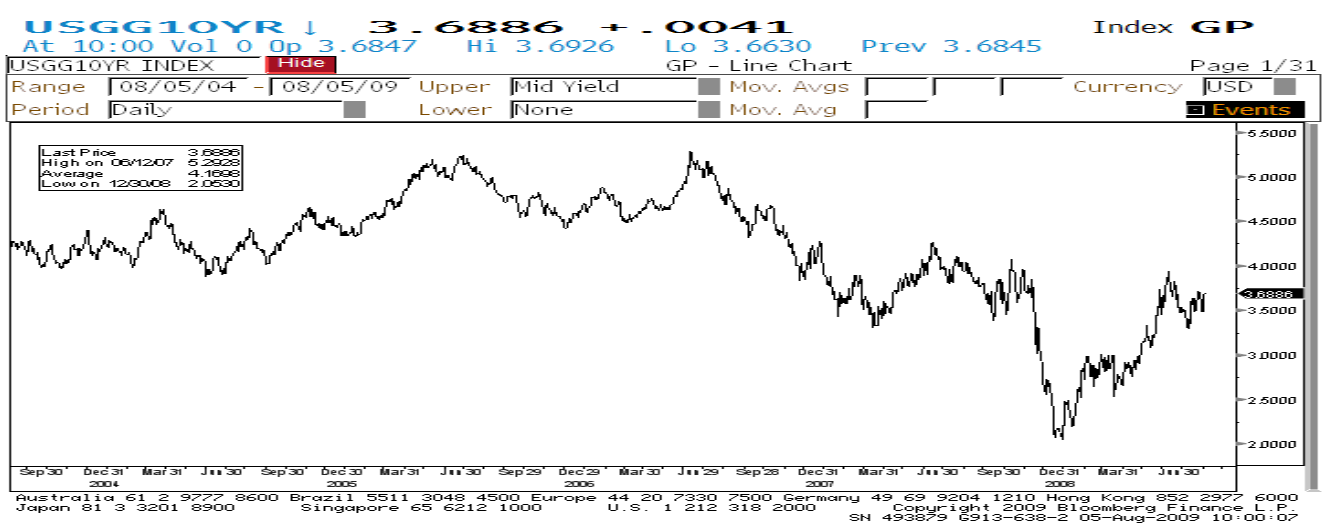


The equity market has continued to rally since making a new low in March. Our view remains unaltered that the current move is simply a bear market rally. We stated that the March low would form the base of a fairly wide trading range between 650 and 1000 basis the S+P 500, a trading range which may well remain in place until the latter part of next year. It is important to state that the period Q3 07 to the last quarter, saw the largest decline in earnings since 1936, when data began to be recorded. In fact, overall earnings have dropped to a record low, and if current estimates hold Q3 09 will see the first 12 month period during which S+P500 earnings are negative according to research conducted by Ed Steer. Our overall view is that the trigger for further declines in US and most global equity markets will be a move below the 2008 lows for the US dollar.



The U.S rescue plan most certainly involves creating vast quantities of 'new money', and currency is growing at a rate of 10% per year, which is the highest for 7 years. Viewing currency as a commodity, if it is in over supply then its price will fall unless specific events such as Central Bank intervention or a temporary sharp short covering rally dictates otherwise. A weak dollar has implications for inflation as dollar priced commodities are forced upward in price terms to compensate for potential loss of income in the face of devaluation. Whilst wage inflation is absent at present, higher food and energy prices will add further to the problems of the U.S consumer. A stagflation condition is the one most likely to be seen in the next few years as a consequence.

The bond market is marking time in yield terms, pivoting around 3.65% basis the ten year bond. We have advised caution regarding being too bearish for the present, but do acknowledge that the 2008 low was the last move of a long bull market. Basing near 2%, yields have now embarked on a long move upwards. However for confirmation of this in cyclical terms, a move through 5.2% is needed and this does not seem likely in the short term. The key levels in \$ index terms, namely the 2008 low 71 (currently 77.6) may well trigger the next bond sell off, and will undoubtedly see gold move to all time highs. We remain confirmed bulls of the precious metals complex and feel much higher prices lie ahead. For the short term range trading is the order of the day, but close attention should be taken off these important longer term trends.



UK Update

The UK economy is gradually recovering from the severe contraction witnessed in the past twelve months. In the year to June, the economy contracted by 5.6% with the final quarter, March- June registering a 0.8% decline against a 0.3% expectation. We maintain our call made earlier this year that positive growth would return by the end of this year. Any expansion however is likely to be anaemic and further contraction is quite possible by 2011 as tax increases together with a public sector squeeze.

The biggest issue facing policy makers at present is the inability of current monetary and fiscal policy to achieve its goal of triggering a strong and sustained recovery. In spite of interest rates at record lows and the pumping 125 billion pounds of newly created money into the economy since March there is little sign of a pick up in bank lending growth so necessary to stabilise the economy. The Bank of England next meets on the 5th/6th of this month and will indicate if the final tranche of the GBP 150 billion quantitative ease purchase of mainly government bonds will take place. A further GBP 25 billion buy-back still remains to be done. More significantly however, is a move recently announced that the Central Bank will buy secured commercial paper which is aimed at increasing liquidity in a way which by-passes conventional bank lending. A new facility would be launched to buy securities based on commercial paper; in effect short term 10u's which companies issue to finance everything from payrolls to consumer loans such as credit cards. The Bank will pay for the facility with funds borrowed by the UK government or with funds authorised by the Bank itself. The extent of the scheme has yet to be announced. Both the U.S Fed and the Bank of Japan operate such a scheme in an attempted to re-liquidity their economies. The extent of the problem confronting the authorities should not be under estimated. The total amount of cash pumped into the UK economy is now equivalent to 9% of nominal gross domestic product. The hope had been that this would be enough to reverse the 4% contraction in spending in the economy in the year to the end of March, the worst post war decline in normal GDP. The 0.5% official base rate will most likely remain unchanged until well into 2010.

The bank rate is almost irrelevant because the real cost credit remains expensive and is set daily at various rate which reflects both the availability of credit on the hand and the credit worthiness of the borrower on the other. In an economy, only just beginning a profound restructuring away from the baby-boomer/consumer driven model circa 1955-2005 to a much more saver orientated, manufacturing format, lenders are fully justified in not extending credit as readily as before. To expect therefore, normality to return in a way once assumed to be in keeping with past G.D.P expansion would be a great mistake.

Quantitative ease, whilst initially driving down on government debt and helping to reduce borrowing costs across the economy, yields have now risen to the levels prior to QE. Sterling has risen in tandem reflecting the hope that the recession will soon end.

Our \$1.65 target has now been achieved and we restate our last forecast when we felt a move to \$1.75-1.77 could be seen if \$1.65 was broken decisively. With a greater reliance on exports in the "New" economy as both government spending and consumer purchasing declines in real terms, a strong pound is far from being a positive factor. As with cable, our early year target for sterling to move to 0.84 by mid year was met on the 22nd June. This level makes a key technical uptrend for Euro Sterling and should hold. If broken, a move towards 0.78 cannot be ruled out.

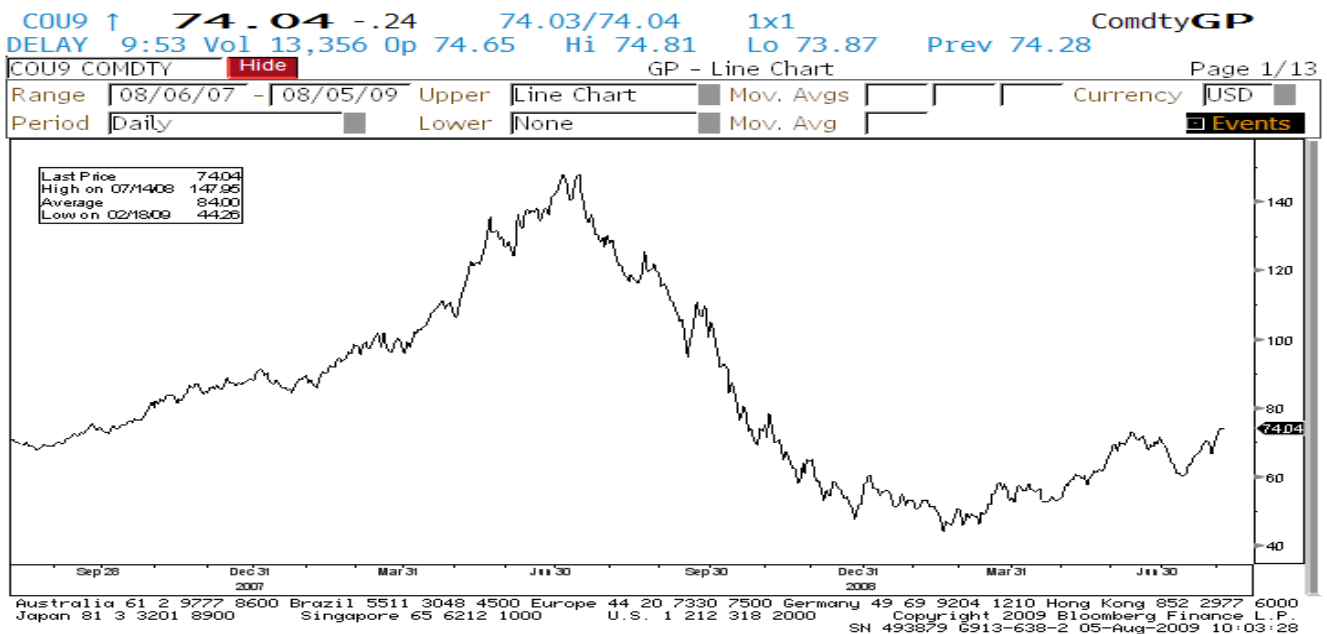
Gilt yield volatility is going to be an increasing factor in the period ahead. Any halt to the quantitative ease policy will send gilt yields higher Furthermore When the Bank of England begins to put rate up a sharp sell off is very likely and exacerbated by continuing large gilt issuance. The size of the gilt market is now some GBP 715 billion compared to GBP479 billion at the end of March 2008. A warning should also be sounded regarding the corporate bond market, a sector which has out performed this year. Any sharp upward move in gilts will impact corporate bond yield and investors could very well be confronted by a highly illiquid market. We remain from sellers of gilts on any rally and feel a full blown bear market, the first since early 1980's may be seen within two years.

Energy

We have favoured a bullish stance towards the energy complex since the early part of the year. For the period ahead however we feel a period of price consolidation will be seen, with front month September Brent trading in a range of \$55-70 per barrel. In the last month, front month Brent has traded between \$59.50 and \$74.03 per barrel and price action is such, that a more cautious stance is warranted.

A large stockpile of both products and crude oil has been accumulated world-wide and in addition some five million barrels per day of spare production capacity exists, mostly in Saudi Arabia. At present, plentiful supply is not seen as a negative to oil traders due to the focus on rising equity markets and the implication of renewed global growth by 2010. We remain highly sceptical of this notion and feel that a prolonged period of slow growth lies ahead. Consequently if the equity market rally stalls, a sharp set back in oil prices may very well be seen. As have outlined earlier, Equity markets will remain in pronounced secular bear trends for some time to come. Increased marginal demand for oil tends to have a significant impact on price. In this context, expanding Chinese demand has been an extremely important factor in global energy pricing for some five years or more. Consequently, the oil market closely follows Chinese economic data, looking for any clue to future industrial growth and fuel demand. In the year to date increased demand from China has been an important part of the bull market move. As long as the current loose money policy remains in place, we feel oil prices will remain above \$50 per barrel. U.S distillate stocks, now at a 25 year high however is a reminder of the economic difficulties now all too apparent in North America and indeed for much of the world. Any evidence as 2009 unfolds, of the current economic recovery in China reversing will see oil prices back towards the lows of late last year.

For the month ahead we feel a defensive approach in warranted regarding the current market. The market feels expensive above \$75 per barrel basis September Brent. Good support is evident near \$60 and we feel prices are unlikely to fall much below the level. Opec policy is intent on achieving \$75 per barrel in the medium term and this should be bourne in mind when the cartel next meets in September. From a macro perspective past comments regarding the erosion of much of the world's production capacity as existing wells produce less. In addition the Iranian Nuclear issue is ongoing as if the deteriorating anti government activity in Nigeria. Short sellers should, as a consequence take note.



GRAIN & OILSEED REVIEW

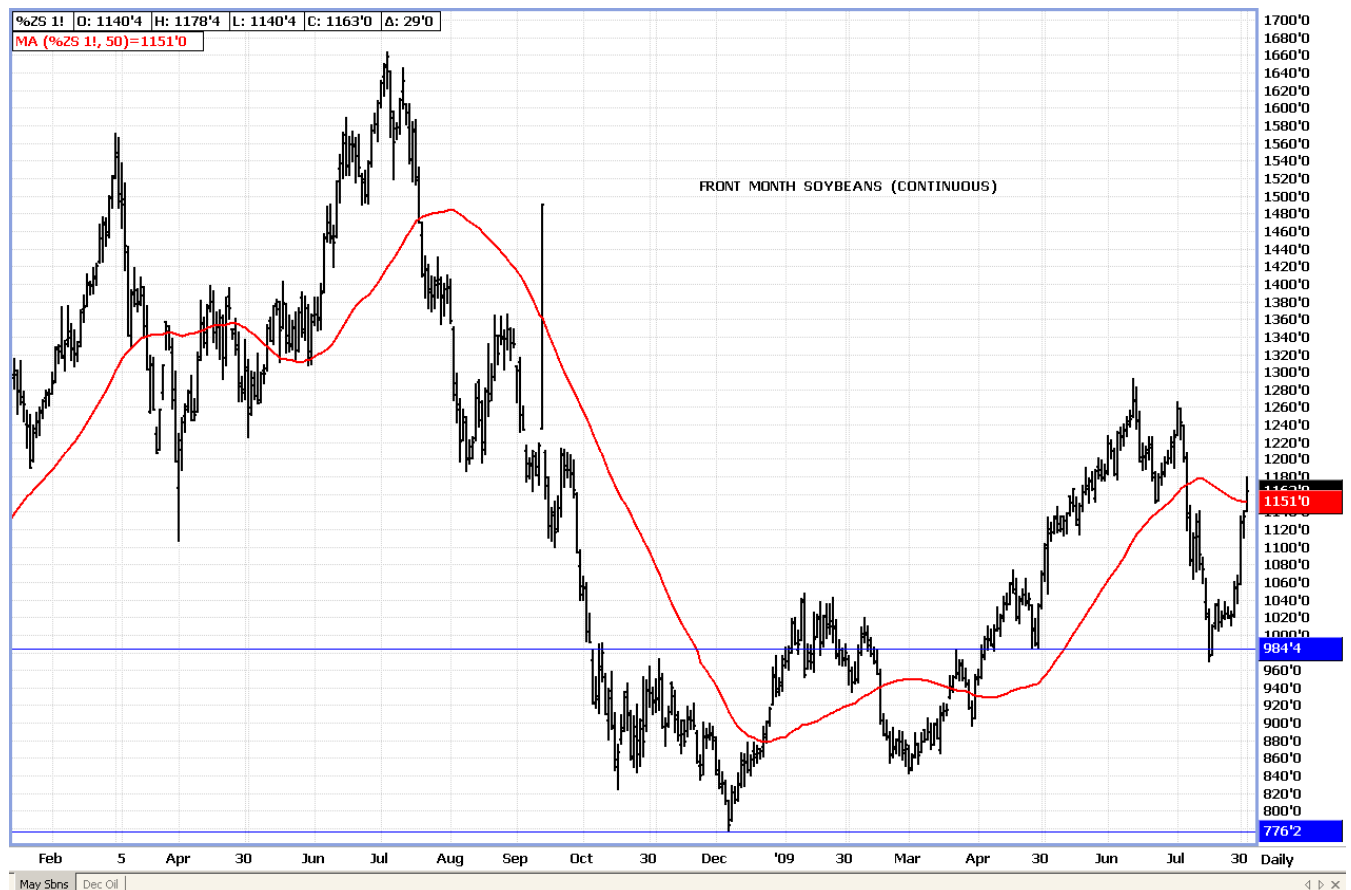


Corn

In the verbatim text of the USDA's June 30th acreage report, the USDA stated the following: "On May 10th, corn planting was 48% complete, down 23 points from the 5-year average. In late May, however, drier conditions allowed farmers to make rapid progress. Farmers reported that 97% of the intended corn acreage had been planted at the time of the survey interview compared with the 10-year average of 98%." When the report was released, the market (me included) was extremely surprised by the increase in corn acreage suggested by the USDA. In fact I also found it a little odd that they were able to report that as of the first of June corn planting was only 1 point behind the 10-year average of 98%, when the weekly crop progress reports had indicated a figure closer to 93%. Depending on whether one takes the USDA report or its weekly crop progress reports, 2.6 mln to as much as 6.1 mln acres of corn was still not planted as of June 1st. Well towards the latter end of July the USDA have had a re-think and have decided to resurvey several states including the very important state of Illinois in its August crop report. This is providing an interesting edge and considerable uncertainty over the fast approaching August 12th Crop Report. The market is factoring in around a 500,000 acre reduction in corn acreage from the USDA's June 30th estimate. I on the other hand having returned from my crop tour would not be surprised to see that figure closer to 1 mln acres when all is said and done. The USDA will also release its first yield survey of the summer in this upcoming August crop report; a very difficult job I believe given the maturity of the crop

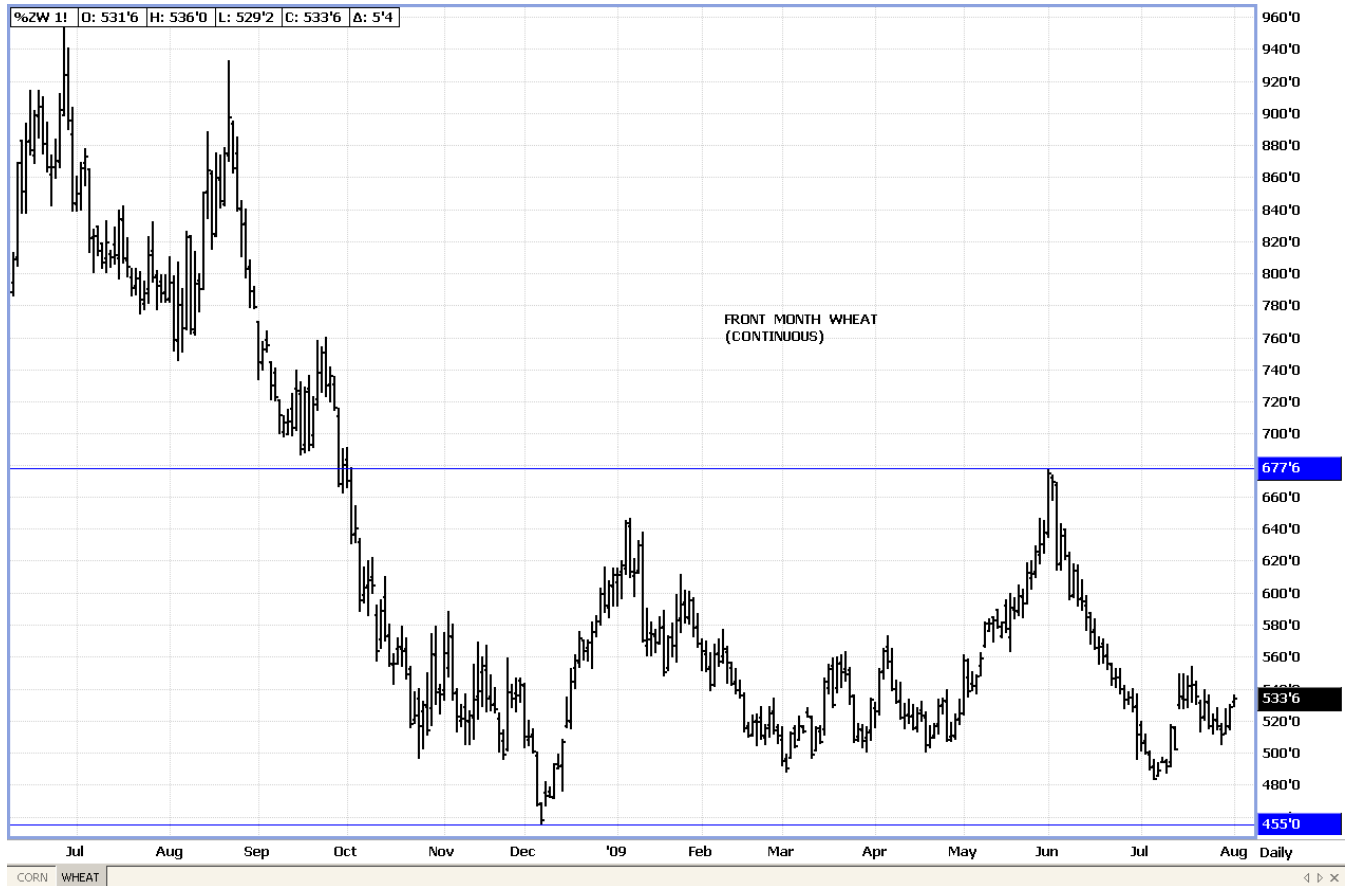
and the lack of heat units available to the crop. I suspect therefore that we may see an unusually large variance in yields and production in each subsequent USDA Crop Report through to the final figure next

January. The best advice I can offer therefore is to suggest that if you don't have to have a position in the market over the report, don't!



Soybeans

The continued weakness in the dollar and the surprising and impressive purchase of old and new crop US beans by the Chinese this past week, the latter seeing one of the largest reported daily sales announcements, has empowered a strong rally from the July lows. This rally has occurred in spite of the generally held possibility that soybean acreage could be increased in the August crop report following the USDA's announcement that they are resurveying certain states in this month's report. So with the first yield survey of the season to boot in this August report, the potential for a major change to the current USDA production estimate and thus projected carryout stocks seems very high. I have also just returned from my annual crop tour of parts of the Midwest and more than ever see the potential for sizeable production swings as we enter the crucial weather month of August & now because of the young nature of the soybean crop, the months of September and October as well. As with the advice in my corn comment, it would be a brave and perhaps foolish man to gamble on the results of this approaching report!



Wheat

A weak dollar is of course providing a measure of support to wheat, as is the bounce in corn and bean prices. Sizeable downward revisions to the Canadian wheat crop and concerns over the vulnerability of the US spring wheat crop to an early freeze, together with a generally oversold market also provide more fundamental support to prices. Yet for all this, it's generally difficult to get bullish on wheat when so many other production areas of the globe are doing so well. The International Grain Council for one has just raised its global crop estimate by 2 mln tons. The nearby front month looks to me to be stuck within a \$5.00 to \$5.60 range over the short-term, with the market eventually wanting to see whether an El Nino effect is going to hamper production in the southern hemisphere this autumn. Of course if row crop prices slide later this summer, then wheat prices are likely to slip below \$5.00 on more permanent basis.

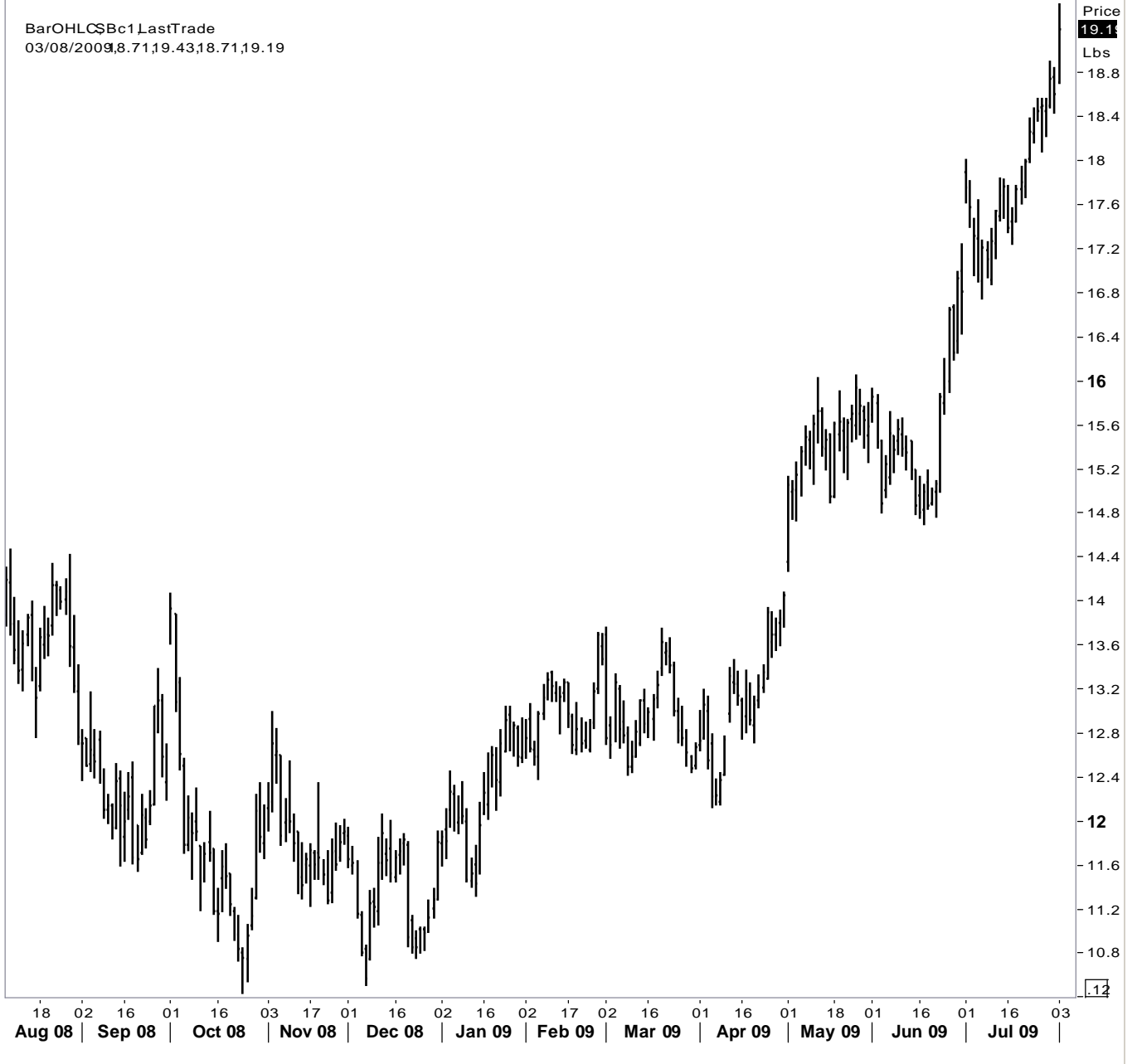
Sugar

The market continued its upward surge last virtually unchecked, the highlight being the March 2010 contract hitting the psychologically important 20.00 cents a pound, but given the final day of the week coincided with month end profit taking prevented it any further break higher. The market was helped by the news that India would allow an extension of the duty free period for raw and white sugar imports, although the news was widely predicted so did not cause any surge, but did add to the overall bullish undertone that is in the market. A steady stream of news regarding the lack of rains in India and worse than expected progress with the Brazilian harvest also helped to support the market and take the Oct/Mar spread into a 98 point discount. Despite all the bullish factors the move higher was not accompanied by huge volumes, or characterised by sudden surges, it was more a steady climb, even when key levels were reached, which is probably why good profit taking was noted at the end of the month as the bulls felt confident to book some profit but were likely to see further gains in the future so did not need to close out all positions. While the focus has largely been on the main protagonists India and Brazil, one eye was being kept on the USA, particularly those watching the white sugar market, as it appeared that the US was gearing up to import some whites. Speculation about possible U.S. sugar imports have been bubbling in the market after the U.S. Agriculture Department said in its monthly report the closely watched stocks-to-use ratio fell to a tight 3.4 percent from 4.3 percent in its June report. Normally, USDA would prefer the ratio to stand at 15 percent, when the ratio fell to around this level last year, the USDA ordered emergency imports of 300,000 short tons to head off a shortage. However, the lack of action so far has lead some to question whether or not they will import, or perhaps delay until next year. One trade house recently said in a monthly report the U.S. and Mexico face a combined sugar shortfall of around 600,000 tonnes in the next few months and would restructure a regional import program to plug the gap, with most agreeing feeling that there is ample time for the gap to be plugged should the need for imports still be there in a few months time. It is a similar situation with India, where most people assumed that they would have imported sugar sooner, instead they are using up stocks. It is the nervousness about the lack of buying in the physical market that has meant that some have not had the conviction to come forward and buy, but is also the reason why we have not seen the market retrace violently as there is very good support below from a lot of destination buyers, and the longer they hold off and use stocks the more violent and sharp a final spurt higher could be when the world really needs this sugar toward the end of this year and the beginning of 2010. In the meantime the focus for the market will be the progress of the Brazilian harvest, and while some recent weather has spooked a few, it will be over the coming months that the amount of rain will be critical. To be fair apart from demand destruction there is not a huge amount of fundamental news on the horizon that could bearishly impact the sugar market, although one or two are concerned about the potential impact of any new CFTC regulation on the market. Softs traders are concerned about recent calls by US lawmakers to the CFTC to move aggressively to crack down on excessive speculation in the energy markets, with one congressman pointing to the CFTC's own data as evidence for much needed action. For the short term there appears little or no reason as to why the market will not test and break the high from 2006 at 19.73 cents/lb, as few are willing to try and pick a top to the market at the moment especially as there appears to be constant stream of ammunition from those wishing to play the market from the long side. Given that the entry points of the longs are now so far below current levels it is unlikely that we will see any sharp pull back for some time to come, especially as most producers now appear to be around 80% fixed against the October contract and are in no hurry to sell more with such strong fundamentals.

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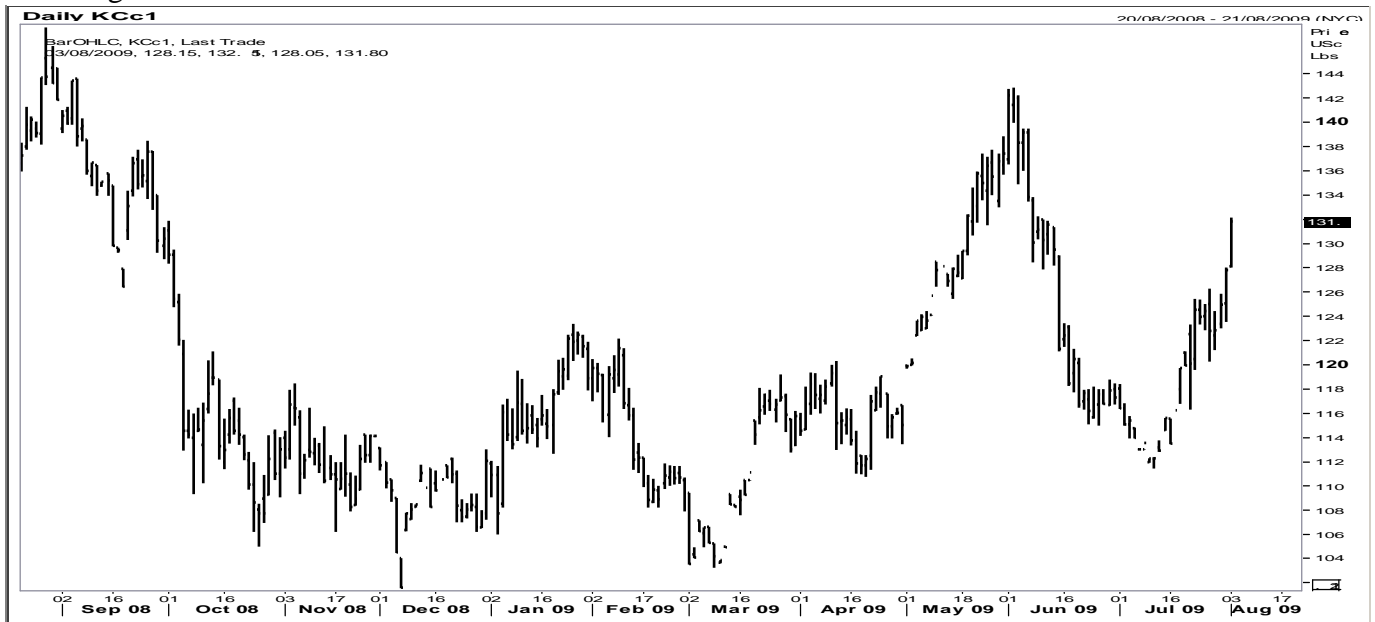
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Coffee

Traders have had a rollercoaster ride on coffee since our last report. Prices dived substantially in mid-June as the funds liquidated longs finding limited buying interest from roasters. The situation was also exasperated by producer selling who had held off pricing as the market rallied in late May. Values have shot higher again as the funds regained their appetite for coffee (and most other commodities). The fact that we entered the frost season in Brazil also limited selling. Currently, prices are near 7 week highs and with the funds having ample ammunition prices could move higher still. The collapse of prices back in June did emphasize that, from a fundamental perspective, there was little reason for prices to rally. General supply is more than adequate and with consumption, at best, flat prices are probably fair value at current levels. The Brazilian winter has been mild with little cold weather concerns so far. As we move into August the threat of a frost diminishes considerable. Traditionally, prices tend to slip as the winter ends. The next weather concern is then the arrival of the spring rains. Sustained rains will allow a good first flush of flowering. The danger is that dry hot weather will appear just as the flowering gets going which could lead to poor cherry setting. Long term weather forecasts are predicting normal rains for the spring. If this is the case then a huge 2010/11 crop could be likely. Turning to the other major producer, Vietnam, all seems set fair for another big crop. While the 2009/08 crop will not be as big as the previous season (23 million bags) it should be big enough (18-19 million bags) to produce a global surplus for robusta. Many have commented on El Nino's return. Traditionally, this weather phenomenon normally has little impact on coffee production barring Indonesia which can suffer from severe droughts. However, it has only had a marked impact on Indonesian production back in 1999 when the El Nino was the strongest on record. So, in summary, currently there is little reason for prices to rally significantly from current levels from a fundamental outlook. Indeed, assuming a normal Brazilian spring prices may well fall as the prospects of a possible record Brazilian crop is absorbed by the markets. Nevertheless, the funds may have other ideas. A weaker US dollar and a more optimistic view of the global economy may well see commodities rally including coffee.



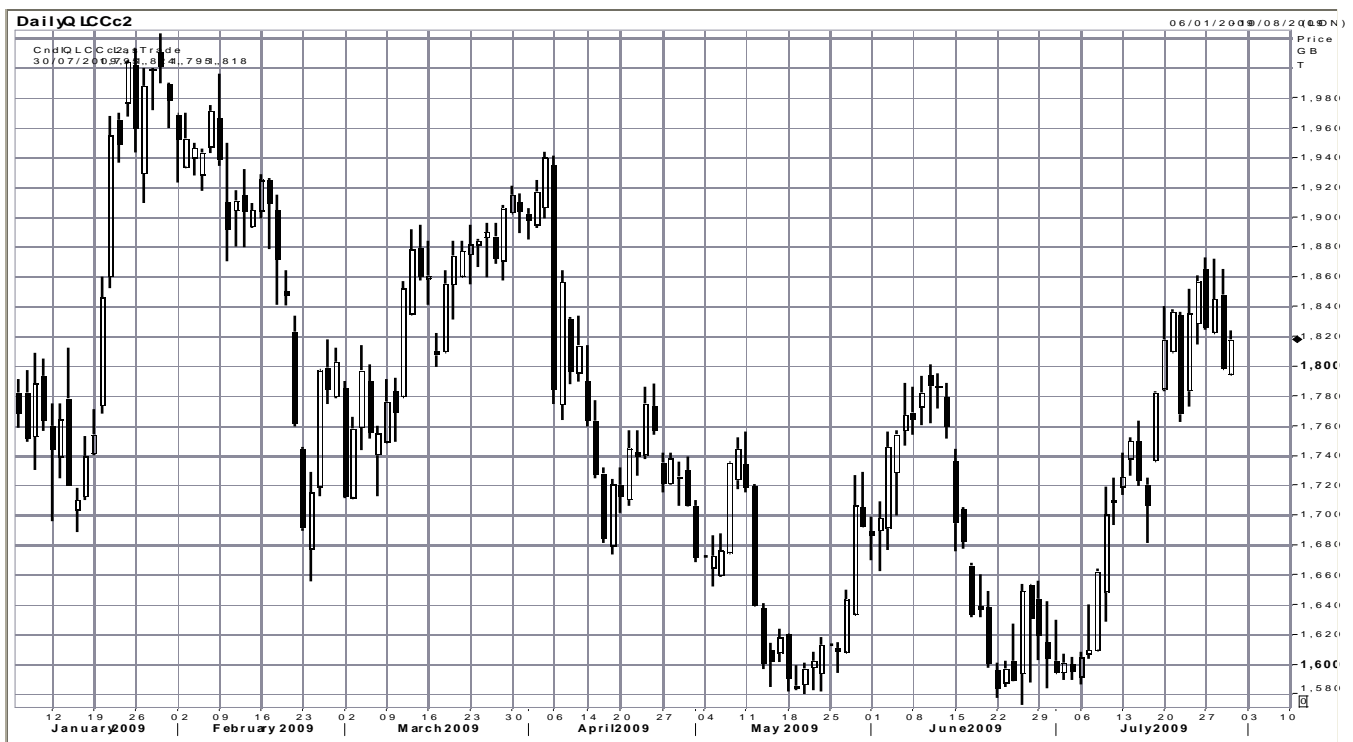
COCOA SUMMARY

Cocoa has been trending higher throughout July.

Having once again failed to find its way lower through yearly lows in May and June, Cocoa has reversed and trended strongly higher through renewed speculative buying on concerns over crop development, question marks over perceived poor demand and strong external performances in the commodity indexes. Indeed, above average heavy seasonal rainfall in early July did raise the spectre for the potential of additional fungal disease. However, rains have eased in a seasonal fashion and do look optimal and may even suggest an early start to the West African season. The consumption outlook remained negative with the European Q2 grind coming in at down 12%, however, the subsequent US grind of only down 6% and a series of better than expected sales figures from major manufacturers has subsequently re-ignited the debate about global demand/supply. As a tonic to the trend, the market has been buoyed by strength of Commodity indexes, reflecting impressions of a global recovery from recession?

Cocoa trading would appear to have entered the so-called "Silly season". We are seeing volatile price swings in generally light volume with large daily ranges. Market volatility is due to a lack of seasonal participation and knee jerk reactions to the latest crop trekking and order flow. However, we expect a return of trade participation with the development of the West African main crop towards the latter half of August.

Cocoa would appear to be technically over-bought and exhibiting lack of upside momentum, leading to a good probability of correction. However, caution is still the name of the game. The market is still vulnerable to speculative flurries and outside influence.



London 2nd month continuation

FREIGHT REVIEW

The downward movement of the dry freight market mentioned in the May report stopped after a few days. Instead, an unexpected upward rally took place during June. Especially the Capesize index increased considerably and surpassed the USD 90,000 mark in early June.

On the one hand this was mainly driven by the Chinese who continued their iron ore and coke imports as their domestic steel output increased, and on the other hand higher than expected thermal coal imports to Japan and India supported this development. Besides that, another key driver is the continuing discharge congestion in China and increasing loading congestion in Australia. Further support for the Capesize strength, was again caused by the Chinese, who still did not agree to a new benchmark pricing for iron ore having the consequence that spot iron ore prices increased gradually.

During the first half of June the Panamax index rose as well, but both on a lower level and to a lesser extent with prices reaching a maximum of USD 28,110.75.

Only at the beginning of July, especially Capesize, rates fell back and started a moderate but continuous decrease. This continued until mid July, supported by an improved congestion situation (reduction of waiting time). Therewith the Capezise index reached a month's low of USD 50,594 in July, which is USD 20,000 below the June minimum (USD 70,271.75).

Contrary to the Capezise index, the Panamax rates independently followed previous month's trend and kept on showing stable prices of around USD 23.500 during the first half of July.

In the course of the second half of July, the Panamax as well as Capezise indices, stabilized again and rose moderately. However, the Capesize index failed to reach last month's peak price levels. Comparing the monthly average for the Capesize segment of USD 60,966 in July with the monthly average of USD 80,846.16 in June suggest that rates might weaken in the near future.

