Monthly Review

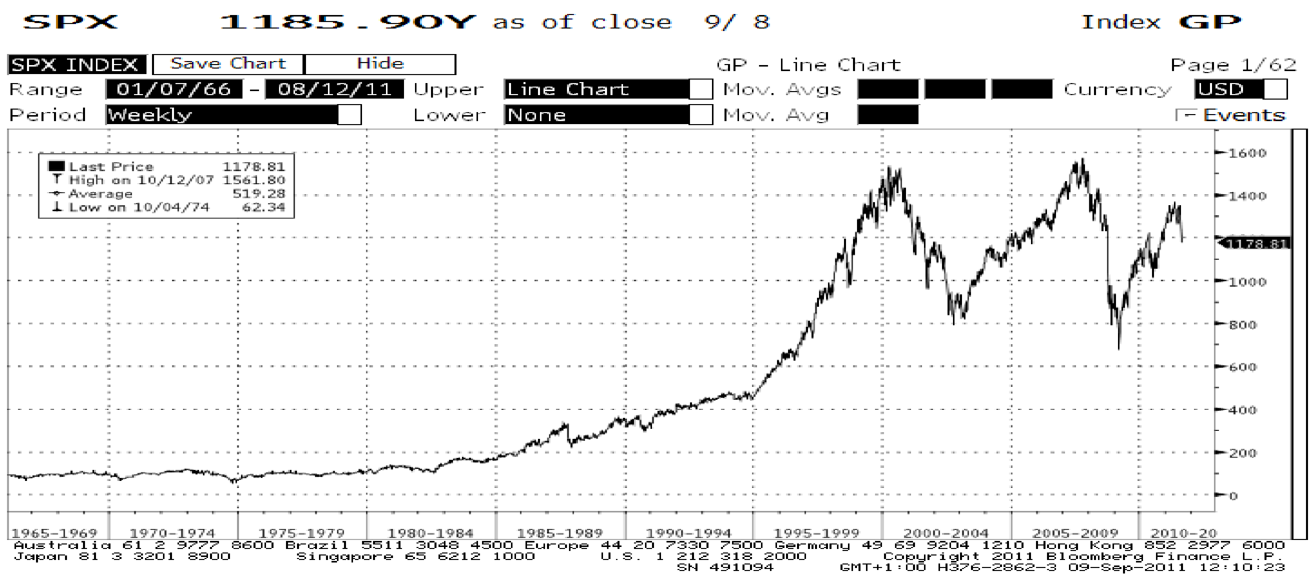
9th September 2011

- Uncertain politics impact financial markets
- The US dollar may begin a bull move
- US Bond yields to continue trending lower
- The sugar rally runs out of steam
- Cocoa to continue to range trade
- Corn and Soya bean prices remain strong

Macro Comment

Rising political uncertainty is now all too apparent in most countries in the world. Many elections will take place in the next eighteen months with the American election in November 2012 being the most crucial. We have previously argued that the end of the long credit expansion would trigger significant political change as a new leaders would be required with a much changed mandate to cope with a new and much more uncertain future. Today's political uncertainty will last for quite some time and it obviously follows that financial markets will be severely impacted during this period. New politicians, particularly in the advanced economies will be confronted by an enormous debt problem. The total debt of advanced economies will increase from $18,000 billion in 2007 to $30,000 billion in 2011 and is expected to rise to $41,000 billion, equivalent to 80% of their G.D.P by 2020. Adverse demographics could further increase debt levels and will inevitably trigger significant political and social tension as a solution is sought. Financing such high levels of debt remains the single most important issue and today, the risk of default increases as countries debt level is deemed, by the market to reach a level which proves unsustainable. The Eurozone for example, is confronted by this very issue as countries such as Greece confront seemingly impossible debt financing.

A second problem confronting all the advanced economies is that of the parlous state of most of the commercial banks. Balance sheets of many of these institutions have been severely damaged since 2007 and continued support from central banks will be crucial to avoid a systemic failure. To expect any sustained economic upswing before the advanced worlds banking system is fully recapitalized is simply not realistic. For a new equity secular bull market to be seen, it follows that the banking sector will have to confirm it has fully recapitalised, and for the sector's equity prices to finally trend higher. The secular bear market in place since early 2000 has more years to run and could easily last as long as the last major bear market which lasted from 1966 to 1982.



US Markets

Confidence levels in the economy are falling rapidly and are back to that seen in 2007/8. The housing market, whilst showing tentative signs of finally bottoming, is still in a delicate state with ultra low interest rates not preventing further mortgage default. 16.2%, amounting to some 25 million people are currently looking for full time employment.. Falling confidence is further impacted by the political environment. The sharp increase in Federal debt is prompting heated discussion regarding how taxation and spending must be changed in order to halt and reverse debt expansion and consequently the U.S is approaching its most crucial election since 1980. The period 1979- 1982 saw a marked change in the fortunes of the country. Policies were implemented which transformed the economy and an eighteen year bull run for equities and an accompanying bull move for the treasury market occurred. The move in respect of the bond market is still intact, and we may see Yields as low as 1% basis the benchmark ten year within a year.

The dollar is bottoming versus most of its counterparts having devalued by nearly 30% since 2002. In early summer we stated that we expected a US dollar rally would begin in the second half of the year. The dollar is still the world's reserve currency and in an increasing uncertainty global financial and political environment it is reasonable to expect money flow back towards it. It is quite possible that investors are preempting a new political and economic environment as was seen in the early 1980's, when the dollar soared from a trade weighted level of 85 to over 160 in just five years. Interestingly the two occasions when the dollar accompanied a strong economic upswing, namely those of 1980-1985 and more recently 1995-2000, the dollar began its move before positive economic data or equity prices were actually seen. In recently moving sharply higher against the Swiss Franc it is possible that a broader move may begin soon as the Swiss Franc is almost always the lead indicator regarding US dollar direction. The dollar index needs to break and hold above 77 for firm evidence of what we are forecasting to prove correct and a long dollar stance is now warranted against most currencies together with continued exposure to the U.S treasury market.

UK Economic Update

Last month, Britain's dominant services sector slowed at its fastest rate for ten years. The Markit/Cips services purchasing managers index fell to 51.1 from 55.4 in July, its second biggest fall on record. The survey is significant in that the service sector accounts for nearly 75% of the total economy. people are adjusting as best as they can to the new world of tight credit and loss of real disposable income by cutting spending. Accordingly the consumer sector faces a long and painful retrenchment.

Against a backdrop of softening house prices, falling pension values, government induced public spending cuts higher energy bills and petrol prices, it is easy to understand that there is mounting pressure on the Government to take some form of action in order to alleviate the difficult situation being experienced by all sectors of the economy and another bout of quantitative ease is being called for. However, such a move will have little impact we believe. The £200 billion buy back of government bonds has had little or no impact with regard to kick-starting the money multiplier. The proceeds of the gilt sales to the Debt Management Office were simply used by the banks to increase their capital. Very little was lent to the Corporate or household sector and this state of affairs is not going to change for quite some time. Perhaps the only meaningful step the government could take at this stage is to launch a massive attack on the rules and regulations which impact business. The Department of Energy for example, has recently estimated that new environmental polices will increase gas prices by 18% by 2020, and further increase electricity prices by 33% for households. For business, price hikes are greater amounting to 24% for gas bills and 43% for electricity bills. This is just one of the many headwinds faced by the economy. Political reality however is such that little reform will be seen for quite some time.

The UK will into not escape the next European recession which appears likely by year end and last through 2012 and into 2013. Sterling remains especially vulnerable versus the US dollar and any move below 1.58 will trigger a sharp fall towards the low 1.40's and we remain confirmed sellers of sterling on rallies above 1.60. The UK, despite the current austerity plan, has still to implement a significant public sector cutback and an associated major rebalancing of the economy back towards industry and exports and from its consumer central, and local government spending and accordingly a threat exists to the UK's credit rating and the Standard and Poor recent downgrade of the USA must act as a warning to the UK Government that no country is immune from such action.

Energy

Against the backdrop of a rapidly weakening global economy, we continue to forecast that oil prices will trade defensively. Prices have gradually fallen for the last four months and this trend may well continue until the three year bullish uptrend, currently centered on $96 per barrel versus the Brent benchmark, is tested later this year. At present, market attention is concerned with the issue of how quickly Libyan production can be resumed as well as whether any serious supply disruption occurs due to hurricane activity in the United States.

Libyan production amounted to some 1.6 million barrels per day before the civil war began earlier this year. The removal of top grade Libyan oil caused crude oil to spike above $125 per barrel from below $110. Saudi Arabia quickly announced it would make good the lost production and prices have, with sharp fluctuations, trended down since mid year, a trend supported by continued evidence of a weakening global economy. Recent reports from oil industry sources in Libya are not encouraging regarding a quick return to full production. Production infrastructure has been damaged and in some cases destroyed and it has been stated that full production is not expected to take place for some eighteen months.

The loss of just 1.5% of global production and its impact on global oil prices is a telling point and endorses our oft stated point that the supply/demand equation regarding the energy sector remains extremely finely balanced. For small percentage of production to be lost which has the effect of increasing prices by some 10% to 25% percent illustrates the fragility of supply. Saudi Arabia apart, there is virtually no spare capacity and existing production capability is rapidly ageing. We will continue to see long term upward momentum in terms of price even if little or no growth is seen in most G-7 countries for some years. With a rapidly increasing global population, expected to reach 9 billion from the current 6.5 in just thirty years coupled with a pronounced trend towards urbanization the price of food, energy and water can only increase on a medium to long term basis in real terms. Basis Brent crude, we believe a firm floor to prices is seen at $95-100 per barrel and whilst we see prices under pressure in the short term, we remain bullish overall.

GRAIN & OILSEED REVIEW

Summer weather conditions appear to have taken their toll on the row crops for the second year in a row, with once again the corn the most affected. But for the renewed talk of a return to a global recession, soybean prices might well have joined corn in also establishing new all time contract highs.

DEC CORN (DAILY)

Once again it has fallen to me to write a few words ahead of yet another critically important crop report from the USDA. Given that crop conditions have deteriorated for a second successive year following our visit to the Midwest ahead of the August USDA Crop report, there is considerable interest as to how drastic the yield reductions could be for corn on this approaching September Crop Report. There is possibly little doubt that yields have declined during the month of August given the progressively poorer condition ratings on the weekly progress updates, but it will be the extent of the reduction that will determine whether new contract highs are to be set or not. In the public domain already, there are some aggressively bullish yield estimates from private analysts that if echoed by the USDA would likely ensure corn price levels north of $8.00 a bushel. But with virtually nothing of the crop in the Midwest harvested at this point, it seems more likely that the market will have to wait until the October report to have a better sense as to how the current corn hybrids have fared under this summer's weather regime. As a consequence I suspect the USDA will be relatively conservative with any yield reductions this month.

Thus prices have become very reliant upon the information from USDA for their immediate direction, though eventually politics, demand and the competition of available feed wheat supplies will play a more important part down the road. For the moment however, the market waits to know from what level of supply it will need to start rationing corn from. So roll on September 12th!

NOV SOYBEANS (DAILY)

Although the U.S weather outlook continues to play an important role in determining the final soybean yields, with plenty of weather still to come, the market seems to be more comfortable with its estimates of soybean yields than with its estimates of corn yields. This of course could lead to a significant variance in the yields the market expects on soybeans versus the ones the harvest will eventually reveal. Following my visit to the Midwest ahead of the USDA August crop report, I came back to the UK harbouring a slight feeling that soybean yields could be disappointing, as although plants and fields appeared to look reasonably healthy I queried whether the pod counts were as good as the visibility of the crop suggested. Consequently given the weather scenario that has faced the U.S. soybean crop during the month of August, the biggest surprise in store for the market could well be unearthed in soybeans rather than corn. That said however, I would be surprised if there were to be any significant change in the USDA's soybean yield estimate this month.

DEC WHEAT (DAILY)

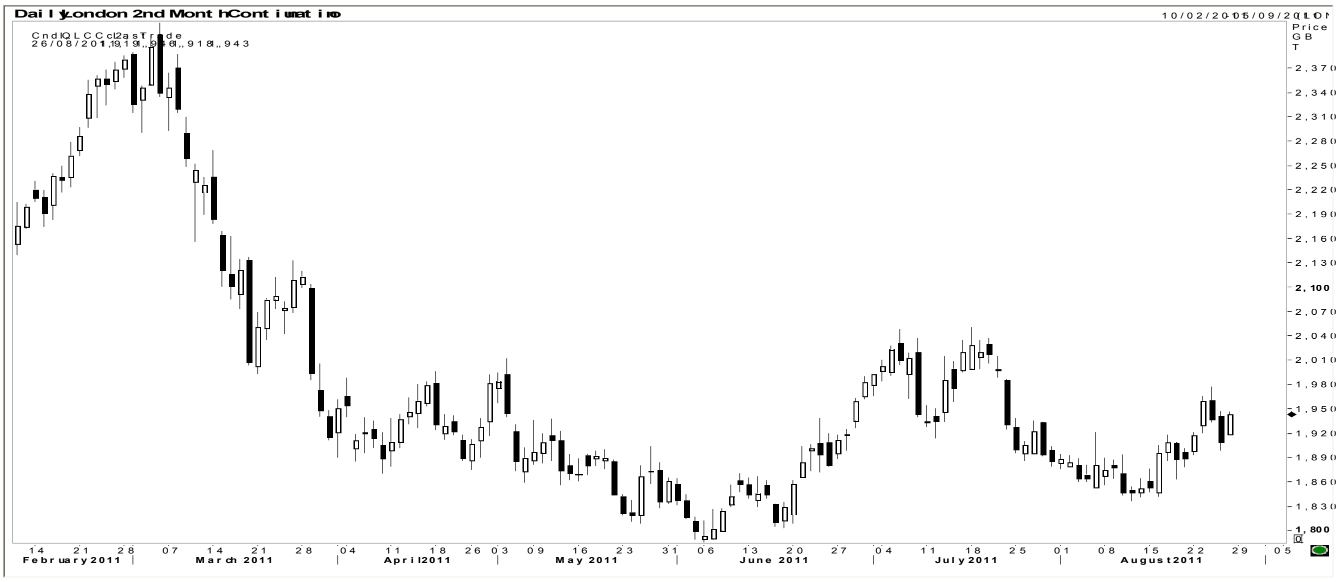
The wheat market has been somewhat lost in the excitement of the developing row crop situation across the US Midwest of late. For although the southern Plains winter wheat areas and then the spring wheat areas of the United States, not forgetting the EU wheat crops, have all enjoyed less than perfect growing conditions this season, the biggest impact to prices and the balance sheet has been the return of both Russia and the Ukraine to export market on wheat. Russia in particular has been very aggressive in their attempts to regain lost consumers such as Egypt, which for the most part look to have been successful. Thus US export potential has suffered, with exports sales around 90% of those registered at the same time last year. As a result one can only assume that had there not been a problem with the US corn crop, wheat prices would be a whole lot lower than they are now. Once the size of the US corn crop is more clearly defined and Russian wheat exportable supplies begin to fade from the market, then I suspect wheat may begin to vie for leadership, particularly if the southern Plains fails to see the moisture it so desperately needs for new crop winter wheat planting.

COCOA SUMMARY

The cocoa markets were unable to sustain recent strength seen in July, falling back to within an overall trading range.

Having been buoyed with some speculative short covering in mid July, the market was unable to maintain that strength, running into some forward Ghana sales and falling back into a buying vacuum, until ultimately finding Industrial support through price fixation and the extension of forward cover. Additionally, continued strong arrivals and exports figures from Ghana and particularly the Ivory Coast underlined the catch-up from their export ban/civil war and the prospect of a final record crop out-turn. The prospect of further weakness appeared to loom large with renewed speculative selling into ongoing scale down Industrial buying threatening the recent 2nd month lows in the US, whilst equity market fall-outs, macro issues and the prospect of weaker global demand depressed commodities in general. However, despite what appeared to have been a clear cut opportunity to resume an overall downtrend, the market failed to take the initiative and bounced back aggressively by un-winding recent weak shorts from the decline. The recent lift on face value can be considered technical, however, an assist may have been accompanied with a more rounded view of the main crop development, which recently suggested a drier period than in recent seasons, therefore potentially less productive and will need to be monitored as we proceed towards the "traditional" mini-dry season.

The market is most likely to sustain the overall trading range, good resistance is likely to be maintained with the follow through of the last "bumper" season, however, the declines as recently seen should be supported in face of new crop concerns and some doubt being shed by a Trade house suggesting demand may be more robust than thought, whilst looking for a more balanced Supply/Deficit situation going forward into next season?



Daily London 2nd month continuation

Sugar

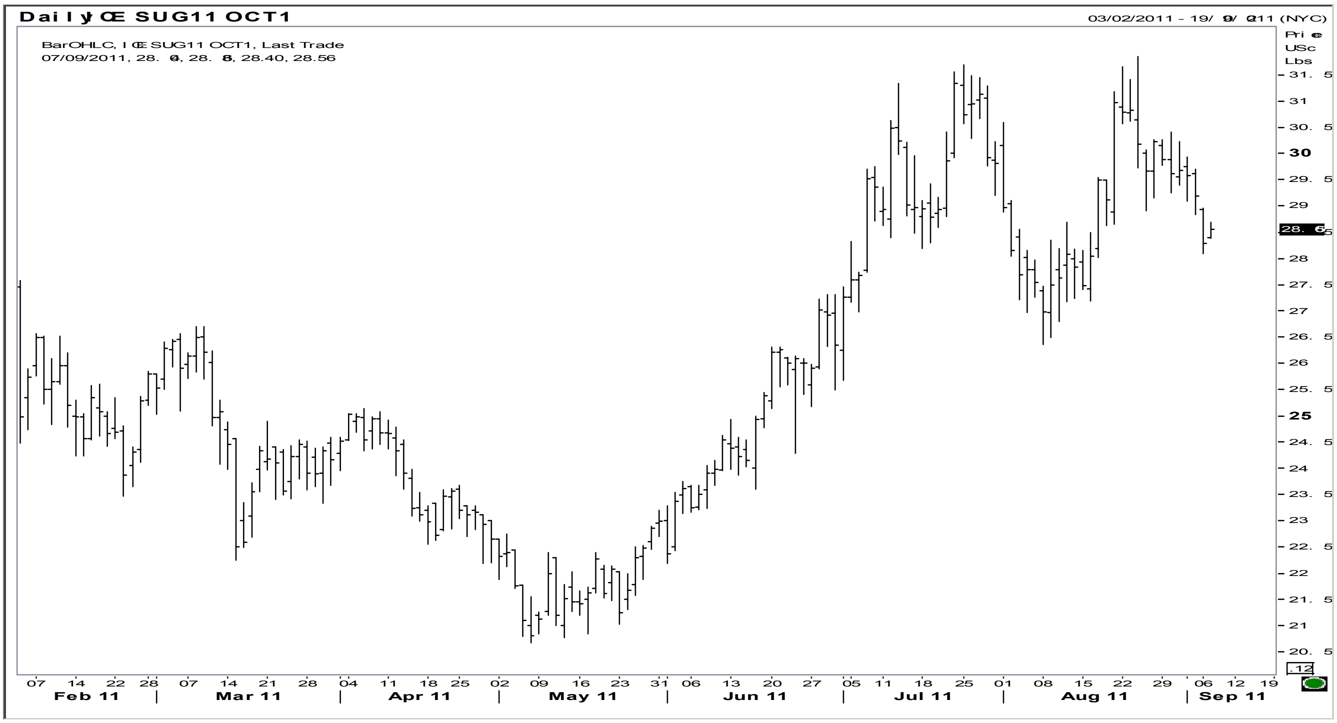
Sugar has remained volatile as usual over the past few weeks. Shortly after our last report prices climbed to their highest level in over 4 months only to drop over 16% before rallying again to make a fresh multi-month high.

The reason for the overall strength can be summed up in one word – Brazil. Back in July the general consensus was for a cane crop of around 510 mt and total sugar production of 31.2 mt – some 4 % less than the previous season. However, over the past few weeks it has become clear that the old adage 'a poor crop only ever gets worse' is correct. Several independent analysts have marked down the crop culminating in the Brazilian Canaplan suggesting the cane crop may not reach any more than 475 mt and sugar production just less than 28.5 mt. While this estimate is the lowest so far the majority put the cane crop at just shy of 500 mt and sugar production at around 30.5 mt still some 6.25 % lower than last season and the majority of early season estimates. As the second half of the harvest starts most traders believe the worst of the news from Brazil is in the market. Poor weather and old cane has combined to producer their smallest crop for over 7 years.

Nevertheless, prices have not been able to hold convincingly above 30 cents for more than a few sessions as increased production elsewhere begins to weigh on prices. While it is too early to put definite figures on the next Indian and Thai crops they certainly look likely to exceed last years crops which, in the case of Thailand, was a record. In Europe and Russia production will be well above last season and both are likely to be net exporters – the first time in 12 years for Russia. Apart from Brazil the only other area which is likely to have a severe deficit is China. Demand there could outstrip internal supply by around 2.3 mt. However, global production is expected to exceed demand by 4-5 million tonnes (Czarnikow) despite Chinese import demand for 2011/12.

Traders now have to calculate when the crops of these various producers will become available. The marking down of the Brazilian crop means that the 4th Quarter 2011 will be a small deficit while the deficit for 1st quarter 2012 has grown to several million tonnes. The key now is whether consumers can muddle through or delay purchases until prices drop. Demand destruction has defiantly been seen and we suspect consumption will fall further in several regions unless prices see a serious drop for their current levels.

In the short term the October expiry is concentrating trader's minds. With Brazilian physical differentials at historic highs for this time of year there is little chance of any hitting the tape. So any potential receiver is likely just to receive low-quality Philippine and Thai raws – both difficult to place. However, with raws tightness expected to be an issue well into next year one or two of the large trade houses maybe tempted to receive whatever is delivered. Traders wait to see whether the up-coming index roll attracts any potential receivers or not. We expect prices to remain relatively well supported in the short term with end destination pricing still to be done. However, the days of plus 30 cent sugar maybe over for the foreseeable future.


Daily ICE SUG11 OCT1
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BarOHLC, ICE SUG11 OCT1, Last Trade
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Daily SUGAR NO5 OCT1
20/09/2011 (LON)
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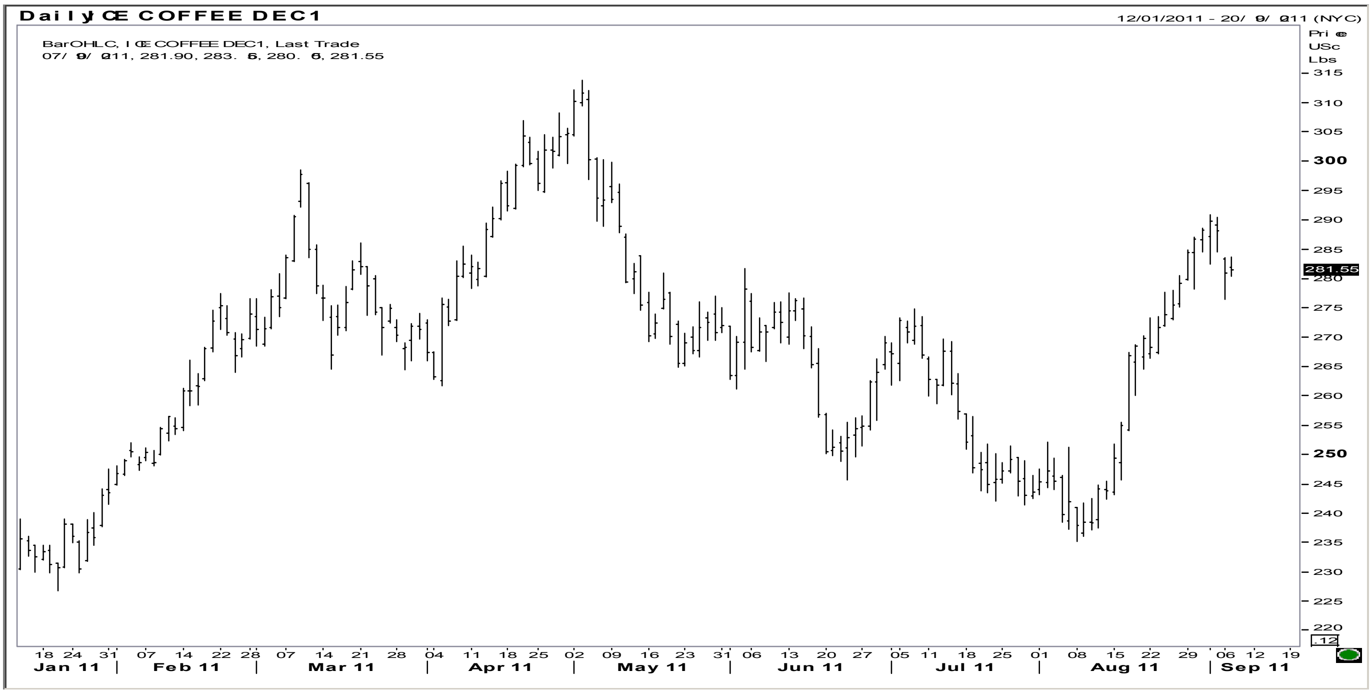
Coffee

We suggested in our last report that New York prices may have fallen enough being some 20 % off their May highs. Indeed this seemed to be the case as prices dropped only marginally more before a recovery was seen. However, we did not expect the recovery to be so large or rapid. In the space of three weeks prices rallied over 16 % with hardly any pull back – levels are now back to their early May levels. Oddly we have seen the London market slip recently despite New York's strength with the arbitrage widening to the April levels again – the widest for many years. The reason is not entirely clear but we suspect some heavy fund selling because of expectations of a large Robusta surplus is the main one.

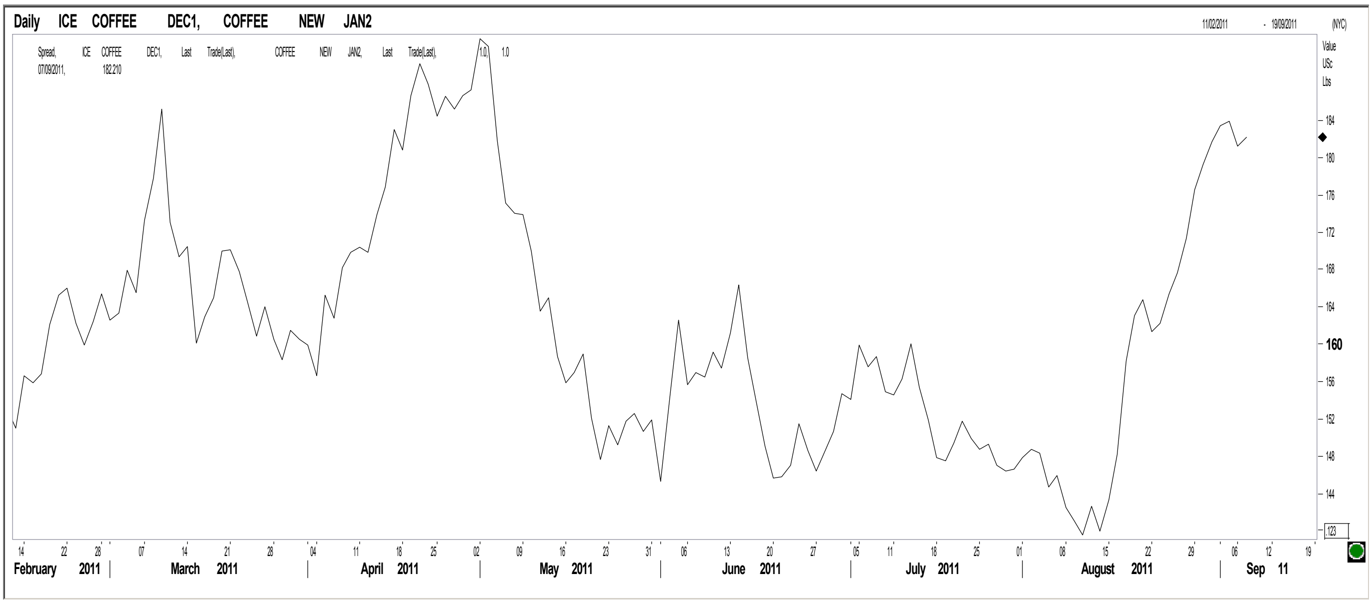
Fundamentally nothing has changed too much. The Brazilian frost season has ended. Another season with no seriously cold weather although there was a couple of reasonable scares – one which resulted in some very minor damage in Minas Gerais. Now we wait the flowering season. Brazilian weather forecasts suggest the rains should start mid to late September which will initiate the flowering. Assuming the rains are regular through to second quarter 2012 then the next crop should be large and of good quality. However, any hiccups in the rain could cause setting problems. There has been some talk about the re-appearance of 'La Nina' which can cause erratic rains across parts of Brazil. We believe that if it does develop it will be too late to have much impact on coffee area weather this season (one should remember that at the height of La Nina in 2009 it started raining a month earlier than normal and didn't stop until may the following year!). However, 'La Nina' could have an impact on production elsewhere with Colombia the main concern. Production here has been poor (9 million bags in 2010/11) for the past couple of seasons with excessive rains the main cause. Farmers are hoping production will get back to their normal 12.5/13.5 million bag levels in 2011/12 and improve further over the coming seasons. A return of 'La Nina' may mean another poor crop. However, it is thought that the chances of it developing is only around 50/50 and it will be mild.

So why have prices jumped recently? Some traders will argue that prices should never have fallen from the highs by so much. A combination of large fund long positions and a negative macro picture had seen an aggressive and prolonged liquidation collapse which did not reflect the coffee fundamentals. Others argue that prices had got over inflated and a correction was needed but it got a little overdone. A slight increase in certified stocks in May after several months of dropping stocks may have persuaded traders the worse was over. However, a mark down of the Colombian crop saw washed Arabica differentials improve again and certified stocks started to drop again. The bulls encouraged by the positive sentiment appeared as buyers while the producers backed off especially in Brazil where internal prices remain very strong. Demand has remained surprisingly robust despite the global slowdown and food inflation that has hit consumer's pockets. However, we saw a large global surplus for 2010/11 of around 10 million bags while 2011/12 looks likely to see another surplus albeit much smaller at around 4 million bags. If the flowering season in Brazil is good then their 2012/13 crop could be huge and means another large global surplus. At current prices every producer will be looking to maximise production. However, while the world has enough coffee it doesn't have enough of washed Arabica which is the deliverable quality that is required for the New York 'C' contract. This shortage over the past year has meant NY coffee prices have been very strong and are likely to remain that way despite the surpluses in unwashed Arabica and Robusta. However, while we do not expect any collapse in prices we would be surprised if prices pushed back above

$3.00 for long unless a weather problem develops in a major producer. Robusta production will see a healthy surplus for 2011/12 assuming the Vietnamese crop has a problem free harvest so we expect the current wide arbitrage to remain.

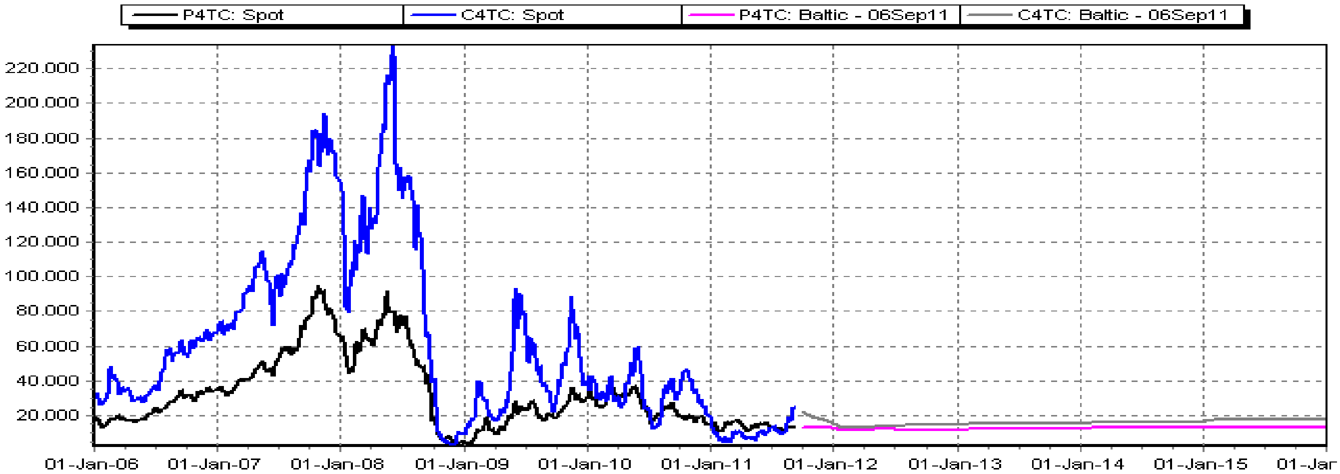


NY Coffee vs. Ldn Coffee Z-11/F-12 arbitrage

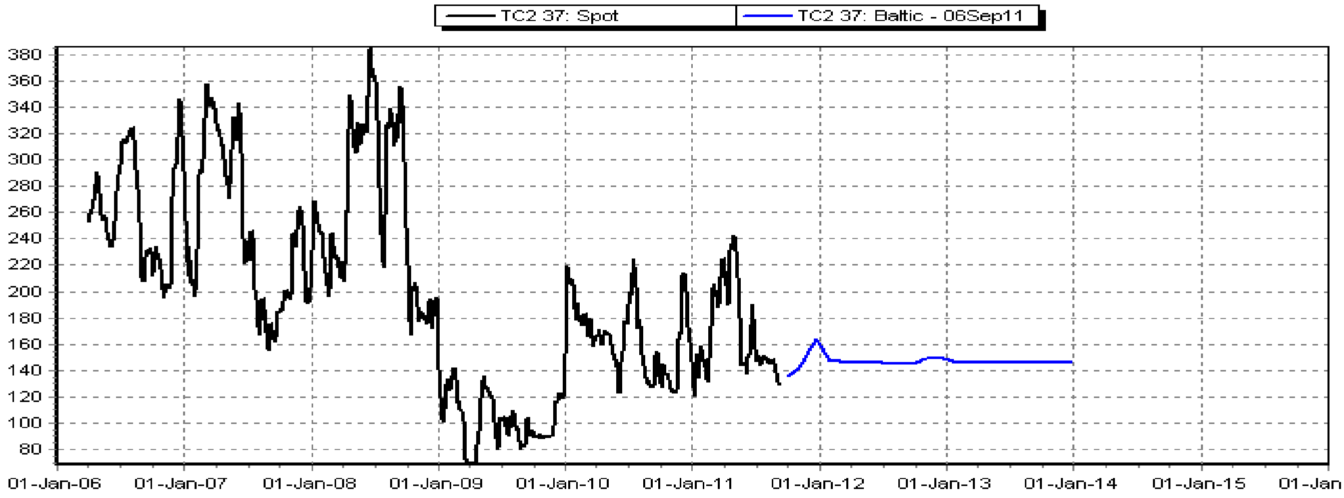


Freight Review

The freight market has been fairly uneventful throughout July and a summer lull was anticipated. Freight rates were increasing in the early stages of the month but soon reached its monthly high of USD 14.111 for Capes and USD 13.519 for Panamax rates. From this point onwards rates decreased constantly to USD 9.407 on Cape and USD 12.061 on Panamax. The solid tonnage supply and the supposedly absence in the market of some big players, which led to only moderate trading volume, put further pressure on freight rates. Throughout August freight rates have been increasing again with Cape levels more than doubling as a lack of available ships in the Atlantic pushed rates. Increased Chinese demand for iron ore and Japan increasing dry bulk imports also supported levels to gain USD 10.320 on Cape freight rates. At the end of August/beginning September we observed the highest levels traded since late November 2009 and this time also showed the highest trading volume within 21 month. But the uncertainty in the direction of the Capsize sector divides industry opinions as some believe that Capsize and BDI gain could represent a start of a recovery for the bulk market whereas others believe that a short term reduction of available tonnage was the only cause of the effect. Paper levels reflected that trend as quickly upward moving freight rates forced market player to get quick cover in the paper market. FFA levels for Q4 Cape contract increased by about USD 3.650 whereas Panamax Q4 contracts rose by about USD 400 from beginning July until the end of August.



The TC2 index decreased throughout July and August from WS 156.25 to WS 138.75. Decreases are mainly traced back to the fact that the Gasoline in Europe has been fairly strong which had as an effect that arbitrages to the US have been shut, so only very few ships have been moving over the Atlantic. But arbitrages are anticipated to open for Q4 and Q1, so increases are likely.



After falling rates for the last 18 months the container route from Asia to Europe saw a slight, although not significant, recovery as the rates stopped falling for 4 weeks and gave the carriers a short time to catch their breath. The route from Asia to both US coast trades did even better as the carriers were able to establish rates increases even though they were not as high as announced.
The difference in rates from Asia to the Mediterranean compared to those to North European main ports is on a long-time (if not on an all-time) high as Mediterranean currently trades with a premium of USD 300.