

## Monthly Review

18<sup>th</sup> November 2011

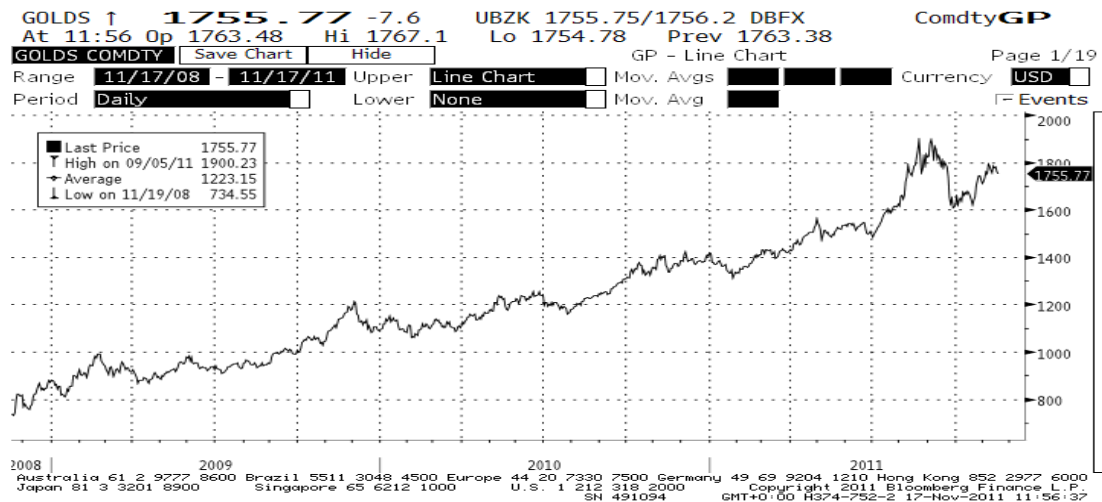
- Default fears within the Eurozone increase
- Crucial debt reduction talks under way in the US
- Little optimism in the UK for any upturn in growth
- Grain and oil seed prices may drift lower into the year end
- Sugar prices remain vulnerable due to selling pressure
- Lower levels favoured for Coffee before year end

## Macro Comment

2007/8 marks the time when a long credit expansion cycle came to an abrupt end. Much of the global economy is or is about to undergo significant de-leveraging and asset price revaluation. A mismatch, in terms of real value, opened up as the credit cycle expanded whereby the value of global assets in the form of property, bonds and equities, far exceeded the value of total world gross product. Accumulated debt has to be eradicated by means of outright default or by negotiation. Only when debts are paid down and asset prices revalued to historic norms, can any meaningful recovery take place.

The global economy is facing declining demand and tax revenues are sliding. This instability exacerbates any existing debt problems. Credit rating will continue to be lowered, which impacts funding costs. Money, in real terms, will continue to be expensive and bank lending will continue to be constrained. The two economies which profited greatly from the credit boom, namely Germany and China, are about to experience a marked downturn in their growth prospects as consumer spending and capital investment declines worldwide.

As global liquidity contracts and market volatility increases trading conditions will become ever more difficult. Many of the products associated with the age of credit expansion are on the way to being consigned to history as trading gravitates to Exchange traded Vanilla products. Indeed, the financial market place will soon revert to that last seen over 20 years ago. The next 18 months, at the very least, will experience difficult market conditions in all the key economic zones of the World. The European project's demise is in lead position, but the US, India, Japan and China are, in differing ways, going to experience an extremely difficult time. We continue to feel that the USD, Gold and the US Treasury market remain the key investment sectors. Gold, whilst being a relatively small but still liquid market compared to the US bond market and assorted currencies, remains a key asset in today's uncertain times. As the chart shows, the bull market for Gold is well intact and new highs appear certain before too long; a move towards \$2,400 remains a medium term objective.



## US Markets

The recent Federal Reserve FOMC statement neatly summarises the current state of the US economy. Economic growth is described as moderate, unemployment is expected to improve at a slow pace and significant downside risks exist when describing the future economic outlook. Inflation is expected to remain at or below the level which is consistent with the Committee's dual mandate. Operation Twist would remain in place whereby mortgage securities would be reinvested and the key Fed Funds rate would remain unchanged until the middle of 2013 at the very least.

The overall picture of the economy remains depressed. Real GDP has grown by just 0.2% in total over the last 4 years whilst industrial production and real retail and food service sales have fallen by over 6% and 3% respectively. Employment has fallen by 6 million and real disposable income is less than in 2008. The housing market remains at the core of the economy and it's post-2007 demise in terms of price, turnover and related indebtedness stands out as the obvious candidate for policy makers to act in order to restore a measure of confidence in respect of price stability. The Fed, somewhat belatedly, is looking at ways to put a floor on the downward spiral in the housing sector and is considering purchasing mortgage debt in order to draw a line in the sand in respect of prices. Consumer and business confidence would benefit if such a policy was successful and the foundations would be laid for a gradual economic upswing. 7.5million US households are either experiencing foreclosure or are delinquent on their mortgage and 11 million homeowners owe more than their homes are worth. Housing has led the economy out of past recessions, it creates jobs and is a catalyst for spending on goods and services.

23<sup>rd</sup> November marks the deadline for the so called Super Committee, a bi-party group of 12 Congressional members, to report on their attempt to find \$1.2 trillion budget savings over 10 years. A full vote of Congress would then take place on the 23<sup>rd</sup> December. The 2012 Presidential and Congressional elections are, understandably, complicating the debate and the outcome for agreement is, at the present time, uncertain. What is certain, however, is that an inbuilt trigger exists whereby failure to reach an agreement would automatically result in \$1.2 trillion in cuts; half of these would affect the Defence budget. With a country credit downgrade already in place, the issue of the US ever growing debt burden is at the forefront of market considerations. For the present, bond yields look well protected against the backdrop of benign inflation and a worsening global economic picture. 2012/13 looks likely to be an extremely difficult time for the US economy and a full recession is likely at some point as spending cuts as well as private and public sector de-leverage take place. The fallout from the European debt implosion will adversely affect the global economy, including North America. Global liquidity and trade is going to be severely disrupted.

We remain bullish for the US Treasury market and Dollar and our objectives for both are unaltered. The Dollar Index can move up towards 86 and possibly higher. Treasury bond yields basis the 10 year benchmark are likely to move lower, towards 1.2% on a medium term view.

## **Eurozone**

Yet another deadline came and went last month and the Eurozone crisis, after over 500 days, has proved inconclusive. Who actually pays for the massive recapitalization of the banks within the 17 member EuroClub remains the central question. In essence, it comes down to whether one country, namely Germany, will underwrite the rest. In simple terms, the massive holdings of Government debt can either be inflated away as the European Central Bank ("ECB") becomes an unrestrictive buyer of such paper (having printed vast quantities of Euros to support such an undertaking) or countries will quite simply default on their debt. Given Germany's experience in the 1920's and the hyperinflation and social upheaval which ultimately gave rise to the all too familiar events in the 1930's and 1940's, it is not surprising that there is a strong German reluctance to trigger a repeat occurrence by acquiescing to Mega QE by the ECB. Indeed, as Bundesbank President Jens Weidmann has formally stated, any ECB action as lender of last resort would break the European Treaty's ban on "monetary financing" Central Bank funding of governments.

To add to the enormity of the debt crisis it is increasingly evident that the European economy is either in or is entering a recession. One, most probably, which will be severe in terms of overall contraction. It should be remembered that as the macro global re-balancing takes place, the two largest losers will be the creditor nations. Germany being the biggest such nation in the Eurozone is a major creditor and exporter and it is going to be the European economy worst affected in the longer term.

From its seemingly distant beginnings in Athens a year and a half ago, the Eurozone tragedy has gathered momentum. Ireland and Portugal followed Greece in declaring partial default and this year larger names have taken to the stage, with Spain and Italy both experiencing difficulties. Austerity measures are triggering widespread political and social chaos. As market pricing exposes one country after another and debt financing rises accordingly, France is now being exposed in respect of the parlous state of its finances. Because of its AAA status, any downgrade would inevitably undermine the already weakened credibility of EFSF and the ECB itself. It appears likely that a downgrade will occur sooner rather than later and this could mark a defining moment in the worsening conditions.

What is possible and indeed highly likely is that one or more Eurozone countries will experience a run on its banks. Already a wholesale banking run is under way with, for example, US Money Market funds sharply reducing the supply of USD to Europe. Furthermore any issuance of unsecured bonds is now extremely difficult and only the ECB is able to provide any day to day liquidity in Euros. A credit crunch is in progress, not helped by imposed austerity programmes, which will exacerbate the impending Eurozone recession. Depression is probably a more accurate description of what awaits. The Euro currency remains a firm sell and could fall sharply in the foreseeable future.

## UK Economic Outlook

The recovery from the last recession, which ended in early 2009, has been the slowest for a century. Unsurprisingly there is growing pressure on the government to adopt supply-side economic strategy in order to rescue an economy heading for renewed recession. Government policy, however, remains focused on the 2010-2015 Austerity Plan and does not look like being changed in any substantial way. The collapsing Euro project is proving very useful from a political perspective, as the dire state of the UK's finances are conveniently removed from the headlines. The UK bond and currency is undoubtedly benefiting from significant capital flight from Europe.

The Euro is gradually weakening against Sterling and could test the 2010 low below 0.81 in the foreseeable future. Gilts can be expected to outperform Bunds into year end assisted by the renewed Quantitative Easing programme which was announced in October.

By virtue of not being a member of the Euro, the UK's deep rooted economic problems are being ignored for the moment. At some stage, probably soon after the final act of the Euro tragedy, market traders will turn their guns on the UK's currency and bond markets, effecting an inevitable re-pricing. While talking austerity and budget restraint on the one hand, on the other the government is borrowing it's way out of trouble; the National debt is due to rise by 51% over the course of the 2010-15 parliament, which is a figure not far short of the one predicted by the Labour government prior to its defeat. Rising unemployment will add further to the accumulating government debt and inflation, though set to begin falling for statistical reasons in early 2012, will continue to be higher than the Bank of England forecasts. Sterling remains a sell on rallies above 160.



## Energy

A pronounced price backwardation exists in the crude oil market at present. This is indicative of a situation where a tight balance between supply and demand is in place. This current state of affairs follows three years of contango when future prices were higher over time. The current backwardation is some \$3 per barrel, and is expected to last into the second quarter of next year. What is increasingly apparent is that oil inventories are low in response to the current global economic uncertainty as oil suppliers fear being caught with unsold stock as demand falls. Unsold inventory being extremely expensive to keep, last minute buying by the refiners, which exists at present, are forced to pay the much higher prompt price. It is not surprising therefore, that these costs are passed onto the consumer, an important factor in explaining the cause, together with higher taxation, behind the current high energy and utility prices.

It is very likely that oil prices will begin to trend higher once again and confirm the overall bull trend which is some three years old. This would be in spite of a weakening global economy. A continuation of tight supplies will constantly support prices and inventories will be kept low. The geopolitical backdrop will continue to remain volatile and accordingly price shocks will always be to the upside. The energy complex, and crude oil and its derivatives are a buy on dips. If front month Brent breaks above \$115 per barrel, a move towards \$125 is possible.



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## Grain & Oilseed Review

The last major USDA report of the year has now been released to the market without much impact, leaving traders with little fresh news on the fundamental front to consider ahead of the New Year, unless of course there are some surprising weather events or indeed demand stories to kick-in before 2011 bites the dust. Thus apart from a generally negative trend to prices, the day to day movement of grain and oilseed prices are likely to be principally influenced by the vagaries of the currency markets through the balance of the year.



### CORN (WEEKLY)

The corn bulls will have drawn some comfort from the USDA's last crop report of 2011. For despite the increase in the carryout forecast by the USDA in its November supply & demand balance sheet, the USDA once again reduced yields and thereby crop production to substantiate the well known trade adage that 'small crops get smaller'. On that premise therefore the bulls will be encouraged to believe that a further decline in yields and production could be in the offing in the final USDA Crop Report for the season early next year. Given a US carryout projected to remain well under 900 mln bushels the market can ill afford to see either a further reduction in the crop size or indeed any improvement in demand. In fact the significance and importance of the USDA January report will be further heightened by the additional release of the December 1<sup>st</sup> quarterly stocks report. The report will allow the USDA to assess the pace of demand through the

last quarter, not to mention the accuracy of previous stock reports, so affording the bulls with another possible bullish surprise. This then is what is to come in January. In the meantime however, unless there is a surprising increase to China's import demand for corn (currently pegged at 3 mln tons by the USDA), then rather than some bullish hopes US corn prices seem more likely to trend lower on increased global grain supplies and the strong export competition the Black Sea region is currently providing to US export levels. Day to day prices may well fluctuate on the fortunes of the dollar and the economic crisis, but the overall trend in prices looks negative with prices perhaps headed toward the October lows.



### SOYBEANS (WEEKLY)

Although the wires, media reports and ag commentaries are full of reports as to the economic crisis facing Euroland in particular (such is its importance to the direction of the dollar and thus our markets), the overall fundamentals of the soybean complex are increasingly turning bearish! The South American growing season is underway earlier than normal and under generally good weather conditions. So another potentially large South American crop coupled with a growing US carryout and early indications of increased 2012 US row crop acreage intentions, suggests prices are beginning to buckle under the pressure of these bearish fundamentals. The bulls are of course touting the potential negative impact on South American growing conditions another La Nina event could provide, though as this will take time to unfold the market is unlikely to see any

impact on prices this side of Christmas, if at all. Given any absence of weather as a bullish factor before the year end, bullish hopes will centre on the USDA potentially surprising the market with a larger-than-expected decline in its final production and quarterly stocks estimates in early January. They will also be hoping that the USDA's projected growth in Chinese soybean imports remains on track at a rate of an 8% increase to 56.5 mln tons. Technically the weekly chart above suggests that prices could at least test the gap below the market at \$11.50 to \$11.35.



### WHEAT (WEEKLY)

US wheat ending stocks may well have been forecast to contract slightly in the latest USDA supply & demand report, but global stocks are continuing to increase and it is they that hint at the level of competition facing US exports going forward. The return of grain exports from the Black Sea Region following the Ukrainian and Russian export bans of last season, along with a record crop in India, fresh supplies from Australia and an increasingly dormant US winter wheat crop indicates that the market remains in the grip of a weighty supply situation. Thus it appears to me that without problems materialising in the weather somewhere, or a resurgent corn market, wheat prices could well slide back to last summer's lows before the year's out.

## Coffee

The past few weeks have seen the coffee markets remain volatile with prices jumping around 8 % higher in New York rallying to just shy of 250.00 only to fall back to the same level as this time last month. The main mover has remained the very erratic macro with coffee especially sensitive to the moves in the US dollar and other commodity price. In London prices have continued to drop lower as the expected Robusta surplus continues to weigh on prices. A low for the year was seen at the beginning of November with current prices only some \$50 higher at \$1840.

Fundamentally, there have been no dramatic changes. The critical flowering season in Brazil seems to have progressed well so far. Recently, there has been some talk about dry weather causing some of the flowers to abort before setting. We are assured by various clients and brokers in Brazil that there is little to worry about. The weather forecast suggests temperatures will fall back and substantial rains will fall over the coming ten days. Late last month a couple of Brazilian analysts put the 2012/2013 crop at a possible 60 million bags. We think it will be lower by only marginally perhaps between 58/59 million bags – a similar size to the 2010/11 crop. Cold and dry weather in August and September has meant the full potential of the crop (put by some at 62 million bags) is now not likely.

The second largest producer, Vietnam, has started their harvest. The start was delayed slightly due to a late finish to the rainy season but seems to be progressing well at the moment. Other producers are keen to take advantage of the current good prices so many are expecting good crops for the current season. However, the largest wash Arabica producer, Colombia, continues to struggle to get production back to the levels seen three years ago. A combination of poor weather, immature trees due to their extensive rejuvenation programme has meant that production has suffered and with La Nina likely to be a force over the coming months a jump in production is unlikely for the current season. There have also been some concerns over excessive rainfall across much of Central America. It did cause prices to make a short term spike but production worries were soon dismissed as it soon became apparent there had been little damage to the actually cherries on the trees.

Global production for the current 2011/12 season is likely to be broadly in balance with consumption. Looking forward we see the possibility of a large plus 10 million bag surplus for next season.

One reason for prices remaining very strong over the last year is that, while overall coffee production is above consumption, there has been a distinct lack of washed Arabica which is the only deliverable quality against New York. Certified stocks had fallen to their lowest level for over 11 years. However, recently a large quantity of coffee has been put up for certification (just under 350,000 bags in total) – the majority is passing grading so certified stocks are growing. While we do not expect this coffee to be delivered it does suggest that roaster demand is not, maybe, as strong as some thought.

While the macro remain the dominant factor in coffee at the moment it is difficult to predict price movement over the short to medium term. However, with the next Brazilian crop looking likely to be close to a record and certified stocks building we suggest prices may test the low of 2011 before too long especially if the Euro suffers further problems

and the US Dollar firms further. It should be remembered that at current prices all producers can make a decent margin.

### NY Coffee Z-11



### London 2<sup>nd</sup> month continuation



## Sugar

Over the past month the sugar markets have remained quiet with daily volumes well below the five year average. Limited change in fundamentals plus concerns over European debt have meant the funds have been largely absent while the trade have been mostly side-lined as they wait for the physical market to become more active. Prices did jump in middle of October on concerns over possible flood damage to the Thai crop plus a temporary improvement in the macro picture. As Thai concerns subsided prices slid lower aided by a deteriorate macro as Greece unexpectedly called for a referendum. Since the beginning of November prices have been caught in a narrow trading range between 25.20 and 26.20 basis March. Good scale down trade buying and end destination pricing coupled with limited selling interest has mean prices have held these lows despite a strengthening US dollar and poor macro. On the up side there would appear little reason for prices to rally too far.

Fundamentally we have seen little change over the past few weeks. Concerns over the Brazilian center south crop have subsided as the harvest nears its end. As mentioned before early estimates of sugar production of 34 million tonnes proved to be way off the mark as the cane crop was progressively marked down as the harvest progressed. Wild estimates from the likes of Canaplan of a sub 28.5 m tonnes crop fanned the flames and prices shot higher. However, now it would seem they were a little off the mark. UNICA's latest data for the end of October shows total sugar production at 29.22 m tonnes. Given the crush could continue through to end of November it is likely total sugar production will reach 30.8 m tonnes – UNICA's last estimate and over 2 million tonnes more than some earlier estimates.

There appears to be little problems elsewhere with most large producers expecting good or excellent crop for this season. As mentioned above there was some concern that the Thai crop had sustained damage due to the excessive rainfall and flooding and the harvest could be significantly delayed. In the event the damage was minimal with several analysts suggesting the rain had had an overall beneficial effect on the cane. The start of the harvest is scheduled to start only some five days later than expected. In India the crop is expected to be +25 million tonnes and, therefore, allow exports of, perhaps, up to 4 million tonnes. The market is currently awaiting news from the ministry about whether they will allow exports before the end of the year. Some bulls are talking of lower than expected crops in India and Russia to name but two but, while this maybe true, we doubt it will have any significant impact on the global surplus this season.

Perhaps more of a concern is the prospects for the next (2012/13) Brazilian crop. Most analysts do not expect any significant improvement in the cane crop. Cosan say they see an increase but nothing substantial, maybe 10 % at best. Aging cane and dry cold weather in August and September will impact. Therefore, traders will be keeping an eye on the weather through to the next harvest.

With end-destination stocks low and concerns over the next Brazilian crop we believe there is a good floor in the market at the moment. Talk that Malaysia will be in the market to buy up to 3 million tonnes is certainly holding prices above 25 cents at the moment. Other end-users will be looking to hang on their coat tails. However, we believe producers are not well priced for next year so any rally will be seen as a selling opportunity. The worry is if we don't see a rally before March expiry – there could be a

scramble to sell. The unknown is the macro. We suggest it is likely to deteriorate further making the down side more vulnerable. Therefore, medium term we would see the range remaining within the range of the past 3 months (28.50 to 24.00) but with a test of lower end more likely.

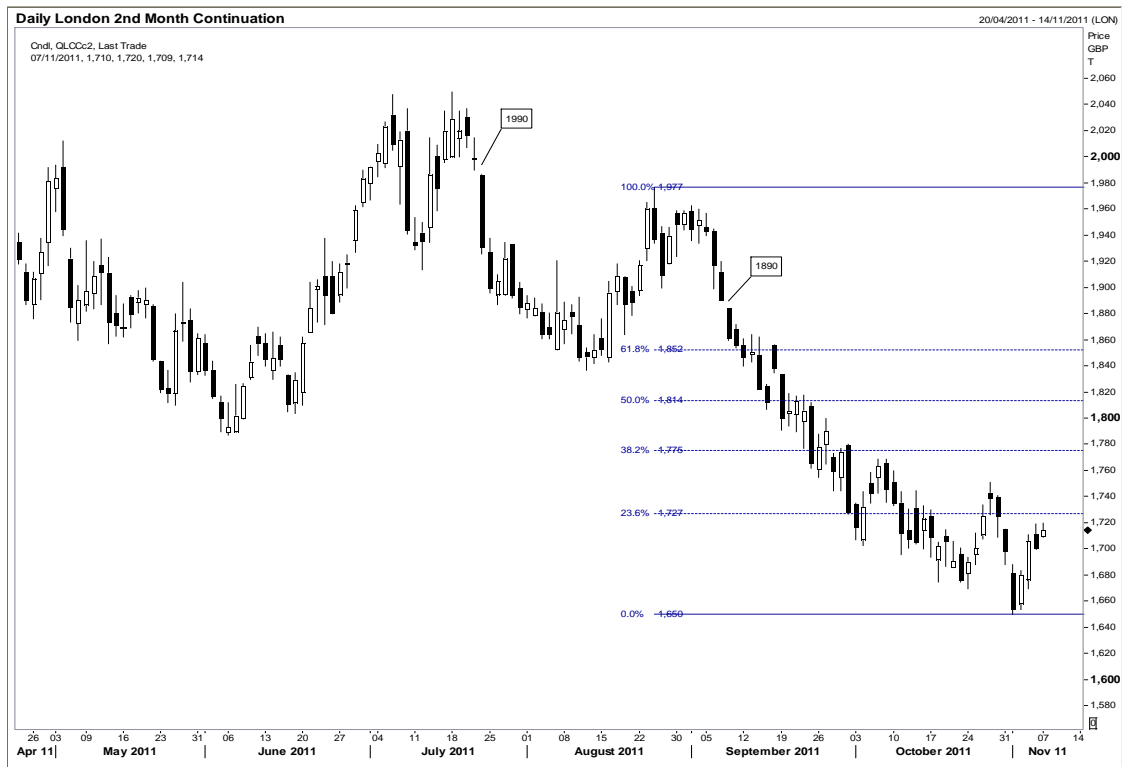


## Cocoa Summary

Cocoa markets have recently endeavoured to consolidate the on-going downtrend with limited relief bounces.

Even taking into consideration a respectable US Q3 grind of +3.42% and a large Euro Q3 of +13.42%, the markets have struggled to maintain any sustained counter-trending initiative. Prospects of an adequate current crop, following on from a record surplus 2010/11 crop have depressed any real opportunity to lift. On going forward Ghana sales and the prospect of Ivorian current crop have weighed on prices. Additionally, the uncertain prospects of a new Ivorian marketing body, forward selling current and new crops has maintained an overall bearish tone. In addition, Macro influences that have depressed equity markets and commodity indexes have over-shadowed Cocoa, prompting fresh fund selling and some long-liquidation. Industry buying has been somewhat muted and limited to the declines, having been a significant scale down buyer, cover is perceived to be good.

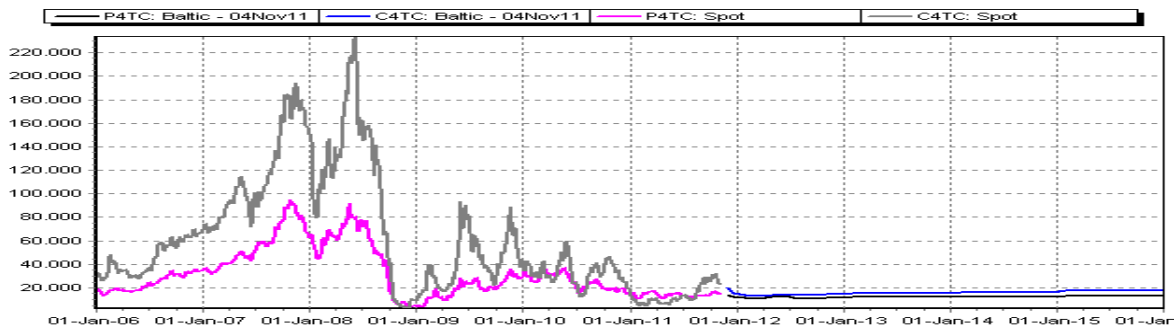
Going forward, the market will most likely maintain a generalised range at these lower levels. The technical ability of the market to consolidate further looks reasonable, notwithstanding, an opportunity for a technically inspired short covering spike to occur; indeed bearish fundamentals may now be well reflected in current prices, which in turn may make the market more susceptible to changes in perception to Supply/Demand balances. Is the jury still out on the quantity and quality of the Ivorian current crop?



Daily London 2nd month continuation

## Freight Review

The month of October starts out with the golden week in China and holidays in Germany. Even though the markets started the week relatively quiet, due to several traders being absent, freight levels were increasing throughout the first half of the month. Cape levels gained more than USD\$6,500 in the first half of October and Panamax levels increased by almost USD\$3,000. Main factor for the support of the markets was the record volume of Coal being imported into China from Indonesia, which pushed up vessel utilization. The latter in addition with the shortage of prompt available tonnage urged charterers to increase their freight ideas. Also, grain cargoes to the Far East as well as Coal cargoes from US East Coast to India, and US Gulf to Continent supported physical levels. By almost mid-month the rush was over, and fresh enquiries were fading, which were urgently needed to establish a positive movement. As the sentiment weakened, mainly due to falling ore prices and de-stocking in China, as well as declining activities, levels decreased constantly. Paper levels followed the trend of the physical market. In the beginning of October, paper levels were supported by the positive sentiment of the physical market. Main trading focus was on Cape front end contracts where main gains could be observed, but as the Coal-Trans started mid-month, markets were getting quieter. The feeling arose that markets might have topped to soon, which led to decreasing paper levels, but the backwardation to spot suggests a lack of real confidence going forward.



The TC2\_37 dipped at the start of October as US arbitration was closed, and there was no movement of ships. When the latter reopened, levels increased again. Many ships that usually come back over to Northern Europe to load were directed to the Gulf coast to load instead, which in turn caused a surge in demand over in Europe. These ships are due to load over the next week, roughly 3 ships per day and should then move out of the region to Europe, the Med, West Africa and South America.

