

## Monthly Review

1<sup>ST</sup> February 2012

- US Interest rates to remain extremely low until 2014
- Recession in the Eurozone to threaten debt financing
- Oil prices should continue to hold above \$100 per barrel
- Ample global stocks force wheat prices lower
- Adequate supply should keep coffee prices in check
- Weakening demand will cap any significant cocoa rally

## Macro Comment

The debt crisis of the worlds high income countries is already four and half years old and shows no sign of ending. Central Banks have provided massive liquidity and ensured ultra low Interest rates remain in place an attempt to alleviate the difficult economic conditions which inevitably accompany deleverage. Rebalancing high income countries will take five or ten years and will be complicated by increased political uncertainty. A factor which will increase financial market volatility as if is likely that greater economic nationalism will be seen as individual governments seek to protect their own interests at the expense of other states.

At the same time as highly indebted first world countries struggle with their problems, it is important to state that many other countries, both high income and developing have been growing rapidly. However 2012 will be a year in which this resilient part of the global economic and financial system, namely the emerging markets economies are robust enough to cushion themselves from the impact of the developed world reducing credit. The World Bank has recently downgraded 2012 growth in world trade to 4.7% from 6.6% in 2011 because of the growing fall in credit growth. The developing world has been reliant on private capital flows from the high income countries. A sum calculated by the World Bank to fall to \$807 billion in 2012, from \$954.4 billion last year and \$1055.5 billion in 2010. It is highly likely that the decline in the capital outflow from the highly indebted high income countries may be greater as the squeeze on risk capital worsens. That global trade will slow markedly this year is therefore is not surprising

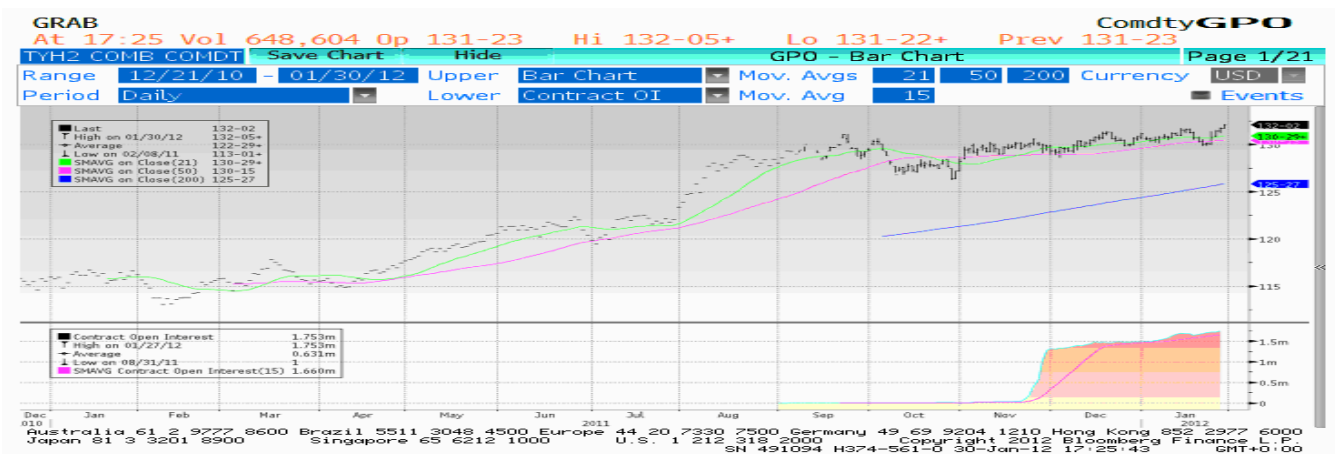
The post 2007/8 trend of enhanced financial market volatility will continue in the year ahead. It may very well be that the emerging and developing countries provide the trigger for yet another shock to the financial markets. There is growing uncertainty with regard to the current state of the Chinese economy for example, and if a greater than expected slowdown occurs, many commodity exporter countries will be affected. Having rallied in the second half of last year, the US currency has corrected lower. The year ahead will most likely see a degree of flat- lining by the majors versus the US dollar. That said however, we still see the potential for the dollar to trend higher and the dollar index will test levels above 86 later this year.



## US Markets

The Federal Reserve has recently lowered its forecast for GDP growth this year to between 2.2% and 2.7%. Unemployment is seen between 8.2% and 8.5% by year end and Core PCE inflation, the Fed's preferred measure, is expected to end the year under 2%, at between 1.5% and 1.8%. The overall economic recovery since the 2008-2009 recession has been markedly sub-par and it will almost certainly remain so in the year ahead. The growth in the economy in the second half of last year was helped by good consumer spending figures. This happened at the same time as household savings fell to just 3.5% of disposable income. A trend that is simply not historically sustainable and on the assumption that the payroll tax issue is shortly settled in favor of a lower rate, the boost to consumer's income will almost certainly be saved. Accordingly going forward, economic growth will be reduced. A second negative factor for 2012 growth will be the ending of the 100% one year depreciation for Capital investment. This economic growth boosting measure ended last month, and will see depreciation reverting to 60% for one year with the rest following over the economic life of the asset in addition, the year ahead will witness a highly volatile political climate which will inevitably mean that many businesses cut back non-essential expenditure until after November elections.

The first quarterly meeting of the Federal Reserve Bank's revamped policy committee took place this month. For the first time the Fed has established an inflation target and also given an Interest rate forecast for three years forward. With 2% being the target PCE inflation rate and the Fed forecasting inflation falling below 1.8% the market has quite correctly factored into Interest rate pricing further quantitative easing, most probably in the form of mortgage bond purchases. By forecasting virtually zero rates until the end of 2014, markets have had to factor in no rate hikes for a considerable period. By stating that unemployment will remain high, at over 8%, the Fed has made it abundantly clear that it will provide whatever liquidity necessary to support the economy. We see no inflationary pressure in the short or medium term resulting from what are now negative real Interest rates. Deleveraging and disinflation remain the dominant themes and this will remain in place for a considerable time. We remain bullish for US treasuries as we have been for a long period and maintain our forecast for 1.2% ten year yields being seen in the next year.

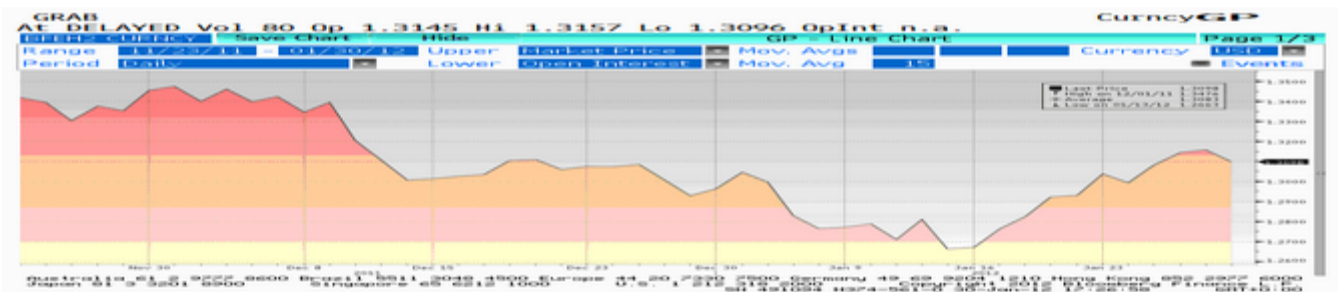


## Eurozone

Faced with increasingly difficult bank refunding at the end of last year, the European Central Bank was forced to release Euro 489 billion three money at 1% interest. This large scale cash intervention has to date, averted a credit crunch for the Euro zone's banks. Short term borrowing costs for the peripheral nations of Italy and Spain have fallen. It is no surprise that Italian and Spanish Banks were the largest takers of funds from this newly created funding facility which has been called the Longer Term Refinancing operation or LTRO by the European Central Bank. With many Eurozone banks having funded their requirements for the year ahead, it is correct to say that any systematic Eurozone banking crisis has been averted for the moment. Part of the proceeds have been used to buy longer dated Sovereign bonds and it is no surprise that, bond yields have fallen. Banks outside the Eurozone periphery however have taken higher prices as an opportunity to continue to liquidate sovereign debt from such countries as Spain and Italy. There will be a further LTRO in February in a further attempt to boost the debt markets. It is no surprise the ECB liquidity add has sparked a rally in many risk assets but we regard such a rally as being of limited duration.

The wider problems of the Eurozone, remain unresolved and particularly crucial issue of Sovereign indebtedness and the details of the proposed fiscal treaty. Furthermore, most countries will register negative growth in the year ahead and the political backdrop continues to deteriorate as austerity measures inflict hardship on the electorate. It is the increasingly unpredictable political backdrop, which has to be factored into investment decision-making this year and next. The talks to restructure Greek debt talks have, as for the moment reached an impasse after Eurozone finance ministers reject an offer from the private bondholders because of the cost of sweeteners on the new proposed bonds. The restructuring deal with its private creditors is a precondition for Greece to get a second Euro 130 billion bail-out from other countries of the Eurozone following the Euro 110 billion it received in May 2010. A solution has to be found by March 20<sup>th</sup>, the date when Euro 14.4 billion has to be paid by Greece to its creditors. One fact is evident, a default is going to take place in some form or other and the main loser will be the Eurozone taxpayers with uncertain political consequences following soon after.

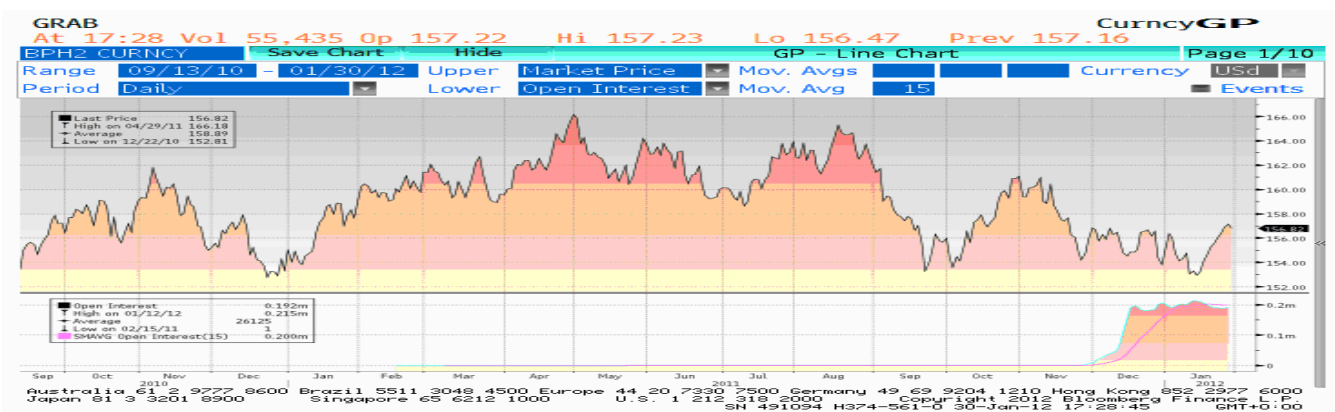
The Eurozone has self evidently fallen into a spiral of downgrades, falling economic output, increasing debt and yet more downgrades. For the moment, the ECB's LTRO support mechanism may well see market through the spring refunding period. However the real issue which remains unresolved is the enormity of the problem, and necessary macroeconomic adjustment. Consequently the currency remains a confirmed sell on rallies.



## UK Economic Outlook

The UK will experience little or no growth in the year ahead. The government's official figure for a 0.7% yearly expansion, a figure with which the I.M.F is in near agreement. In 2011, the economy registered a scant 0.8% increase in GDP. The economy is undergoing its third major change since the Second World War. Large scale state nationalization coupled with the implementation of the National Health service and public spending on housing infrastructure and education marks the first major post war economic phase and which dominated the economy from 1945 to 1979. The Thatcherite reforms of the 1980's marked the second major economic event and economic growth was driven by these policies until 2007. Policies which involved curbing union power and significant privatisation reform largely impacted the private sector and especially the service and consumer sectors of the economy. The latter phase of the post 1979 cycle was dominated by significant growth of the largely unreformed public sector at the expense of the private sector which was subject to increased indirect taxation in order for the substantial expansion to be funded. Following the end of the credit boom in 2007-2008, a new and very different economic model is slowly developing. This will be dominated by the decline in the public sector, and a marked change in consumer behavior. A rise in the savings rate will occur in order to pay for many of the services once paid for by the state. This is happening against a backdrop of massive Public Sector net debt which totaled £1.004 trillion in December. This is equivalent to £16,400 per person and 64.2% of G.D.P. A major financial change is underway with regard to credit which will no longer be so readily available. Against this change business models are already adjusting and it is because of this that it is wrong to be too bearish about the longer term future. Surprise to the upside is perfectly possible regarding growth for example and there are signs that the jobs being lost in the public sector are being absorbed by private business. The trend away from owner occupancy towards rental will be extremely positive to greater labor flexibility and it is highly likely that the destabilising periods of property boom and bust will not be seen for a considerable time.

With the Bank of England Governor recently indicating that more money printing was likely and with inflation falling relatively quickly, a lower pound will be favored by policy makers and accordingly we see the currency trading lower in the first half of 2012 we maintain our forecast for the market to test the low 1.40's in the months ahead.

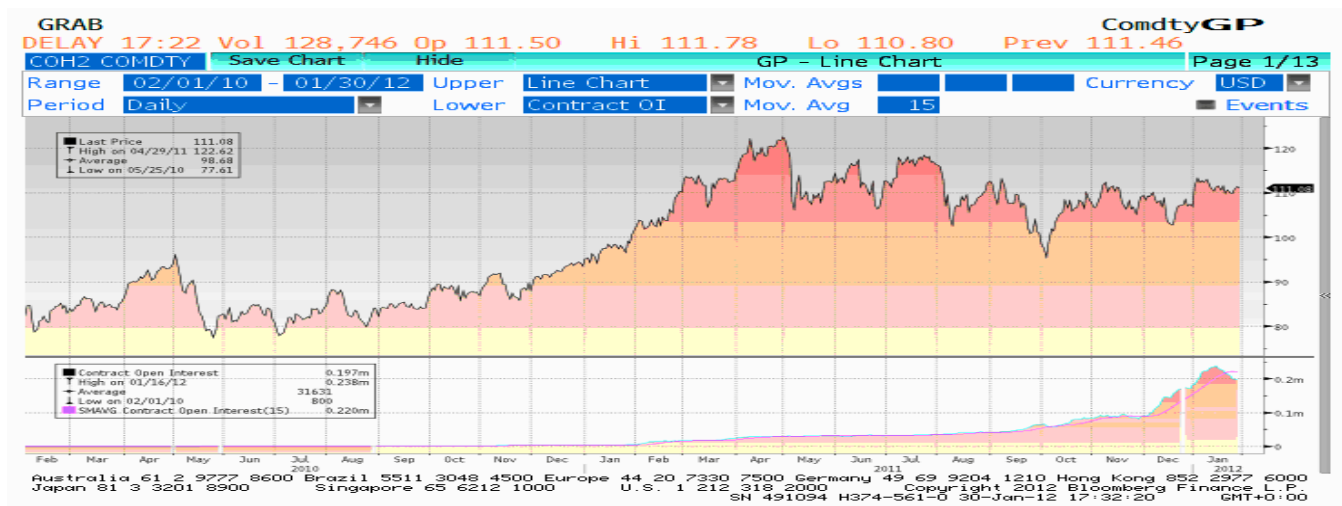


## Energy

The global slowdown is finally beginning to impact oil demand. Consumption fell in the final quarter of 2011 for the first time since the middle of the economic crisis in 2008-2009. The international Energy Agency has recently reduced its demand growth forecast by 220,000 barrels per day from its global oil demand forecast for this year. It forecast an increase in 2012 demand of 1.1 million barrels per day in its last report. Prices, in spite of the global slowdown in growth, remain locked in a now familiar trading range defined by \$100 per barrel on the downside and \$120 per barrel basis front month Brent at the top. A range that has been largely in place since the second quarter of last year. \$100 b.p.d has now become a new reference price for the key swing producer, Saudi Arabia and given that OPEC as a whole moves in tandem with Saudi wishes, it follows that this price will remain a crucial support level for the period ahead. The previous target price, set in 2008 was \$75 per barrel. An important point to make regarding most OPEC countries, who supply some 40% of world oil, is that these countries are using an increasing amount of their own production for domestic consumption. One recent study has concluded that by 2038, Saudi Arabia would require all of its current production, which amounts to over 9 million barrels per day, for its own use.

The potential for prices to break higher remains a real possibility. Increased political instability is being seen in many energy producing regions. The impositions of sanctions on Iran has led the country to threaten a blockade of the straits of Hormuz for example. Iraq, with significant oil reserves appears mired in political difficulties and no increase in exports is likely for considerable time. Nigeria likewise it experiencing increased religious and ethnic tension which, to date has not impacted oil exports but is increasingly concerning the energy market.

Oil prices remain well supported for the present and the market will be well bid on any pull back from current levels. Refinery closures continue to cause product tightness as shown, for example by fuel oil prices which have risen to 2008 record prices and is expected to increase further. The energy complex, apart from natural gas, remains in a long term bull market and this is likely to remain so in the year ahead.



## GRAIN & OILSEED REVIEW

Following a period of excessively dry and hot weather across the main growing areas of Argentina, 2012 has kicked off with a row crop weather market. So amidst all the continuing chaos of the sovereign debt crisis, it would not be a surprise to many if this was just a foretaste of things to come in 2012?



**MAR CORN (daily)**

Argie corn fields have been burning up under temperatures that have in places exceeded 100F, with very little moisture, resulting in the downward revision of the Argentine corn crop. The USDA in its latest crop report this month has reduced the crop by 3 mln tons, though more drastic revisions can be found from other analysts. Of course although Argentine corn production is important to global supplies, the USDA found over 1 mln tons of that Argentine loss through a higher final 2011 US corn production figure. Indeed with the market looking for US ending stocks to have been lowered by 100 mln bushels or just over 2.5 million tons, one could argue further stocks were found by the USDA leaving its carryout unchanged from its December estimate. The most bearish figure of all from the USDA January report, was found in its Quarterly Stocks figure. Against an estimate of 9.361 bln bushels the USDA came in at approximately 250 mln bushels or 6.3 mln tons higher. The net result of all this has been to see corn prices almost wipe out the weather related gains of the last half of December in the two sessions following the USDA January Crop Report. Looking immediately ahead corn prices may well be set to test the December lows in the

March contract at just under \$5.80, but are more likely in the intermediate term to be range bound somewhere between the recent highs of around \$6.60 and the lows of close to \$5.80. The higher end will be achieved if the weather across South America fails to return to more favourable growing conditions.



**MAR SOYBEANS (Daily)**

An Argentine and southern Brazil weather market that helped halt the slide in prices toward the tail end of 2011, by sparking a decent rally in prices from the middle of December, looks to have run its course for the time being following surprisingly good drought relieving rains and a bearish USDA January Crop Report. US 2011 soybean production was raised a modest 10 mln bushels against expectations for a decline, but it was an increase of 75 mln bushels in the Dec 1<sup>st</sup> quarterly stocks figure and a 45 mln bushel increase in the 2011/12 carryout that caught the bulls by surprise to send prices spiralling lower. Following Friday's poor close to last week and the resulting suggested price target ahead of \$11.04 in the March soybeans, it is likely going to have to take a return to the drought in southern Brazil and Argentina if prices are to return to \$12.50 or higher levels over the intermediate term. In fact at the time of writing this report, there is no indication that the weather market has completely abated, with crops still needing additional rains for at least a couple of months to come. The USDA reduced South American production in its January report; with 1 mln tons knocked off its Brazilian estimate and 1.5 mln tons off the Argentine crop estimate. Other key ingredients to the development of soybean complex prices going forward understandably centre on the dollar and energy prices, with the latest strength in the dollar obviously

contributing to the decline in grain and oilseed prices and mitigating any rise in crude oil prices due to Iranian concerns. I do not however expect to see soybean prices below \$11.00 this side of March 1<sup>st</sup>, unless there is a return to near ideal weather conditions across South American growing areas before then.



**MAR WHEAT (Daily)**

The USDA in January increased its estimate for winter wheat seedings by just over 1 mln acres, but although there was a minor reduction in its carryout estimate, the USDA figures were seen to be generally bearish. The US stocks-to-use ratio remains at a bearishly high level, even with the USDA raising its US export estimate 25 mln bushels. Indeed with US wheat supplies failing to compete against Black Sea and EU wheat export sources in the major North African markets, it's currently difficult to understand an argument for higher prices. Globally the USDA raised world production and carryout levels, with Kazakhstan accounting for 1.5 mln tons of the 2.7 mln increase in production. So with increased winter seedings in the US, good current weather for EU wheat crops against a somewhat problematic winter for Ukrainian crops, the prognosis for prices does not look very good at present. I would be surprised to see front month prices above \$6.80, but not surprised if they tested the December lows of just under \$5.80 a bushel given northern hemisphere crops are for the most part favourably dormant. For sure wheat prices could be dragged higher by a row crop weather market in South America, but for the most part ample global supplies and a large stock-to-use ratio should keep wheat price gains stunted.

## Sugar

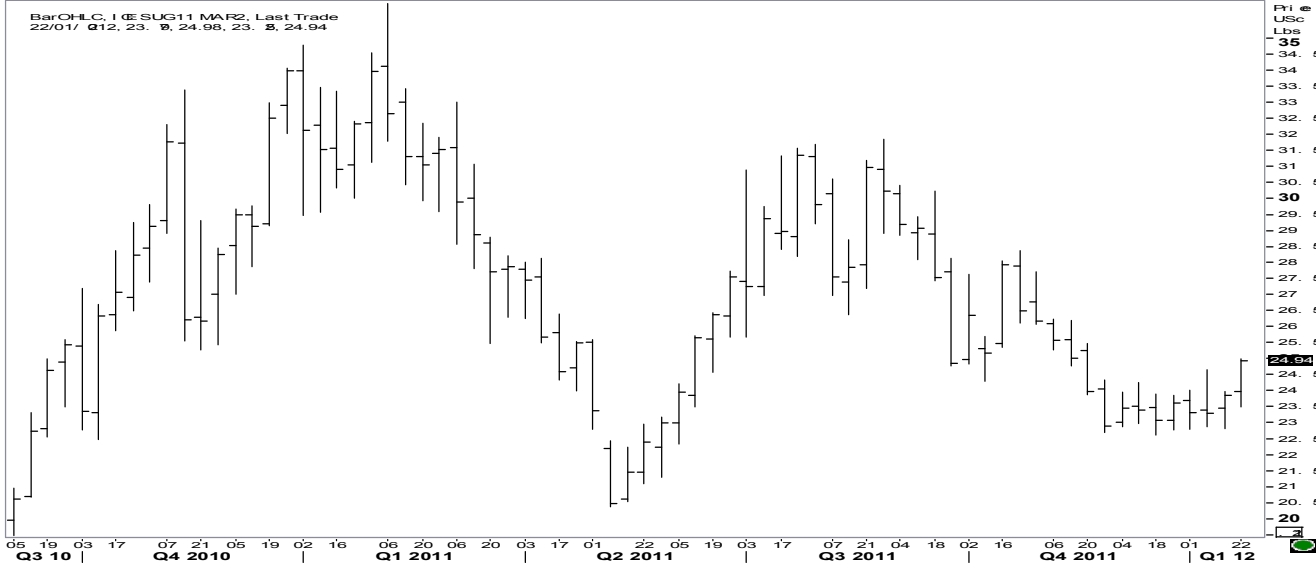
2011 saw very volatile price movements in the sugar markets aided by a very uncertain macro picture. However, the markets inability to accurately predict the size of major crops was the main problem. The market hit their highest levels in decades in early February on an acute 1<sup>st</sup> quarter deficit caused by smaller crops from most major producers and a general appetite by the funds to be long of agricultural products. However, prices soon slumped by over 15 cents as it soon became apparent that the analysts had seriously underestimated the size of the Thai crop. By the time half the harvest was completed estimates had jumped to a record and continued to improve as more and more cane was crushed. This miscalculation mirrored the underestimation of the Indian crop the year before and reminded traders that crop estimation is a very difficult profession despite all the technical aids available nowadays. Traders should have borne this in mind because prices soon started to rally as it became apparent that the Brazilian CS crop had been over-estimated. Analysts started to drop their cane crop estimates in August as the bi-weekly UNICA figures started to lag well behind the previous season's figures. From early season estimates of 540/550 million tones of cane and 34 million tones of sugar we were being told by various analysts that the cane crop would be below 490 million tones and sugar production would be lucky to limp above 28 million tones. In the event the crop did not quite make 500 million tones but sugar production was 31 million tones due to an increase of the sugar ethanol split. Prices soon fell as crops in EU, Russia and Asia came in bigger than expected wiping out any 4<sup>th</sup> quarter deficit. With a large surplus looming for 2012 there was little reason for prices to rally but there was enough uncertainty to stop any major collapse. NY ended the year at 23.30 cents basis March and continued to trade either side of this level for the first fortnight of January.

Recently prices have jumped as US stocks fall to their lowest level for many years sucking in sugar from Central America that was ear-marked for delivery against March-12. Additionally, long range weather forecasts suggest that rain may impede the start of the CS harvest meaning sugars destined to be delivered against May will not be available in time. However, if it had not rained the bulls would be shouting 'drought' by now. We suggest that it is too early to assess the prospects for the crop and the forecast could change dramatically between now and the end of March. As we know analysts track records have not been great recently!! Traders also have to remember that, regardless of a late start to the CS harvest, we are going to see a large surplus later this year so any rally maybe short lived and probably will not attract the fund volume seen in the past two years – for them the 'sugar story' is over. Latest estimates put the global surplus at around 8 million tonnes for 2011/12. However, with deficits for the past two years many end destination buyers are keen to replenish stocks. Many are aware that another deficit could well be seen in 2012/13. The Brazilian cane crop is not going to be much more than 520 million tonnes and could struggle to get above 500 million tonnes. The next Indian and Thai crops may well drop as competition from other crops mount especially if prices drop. Underinvestment means we are unlikely to see any meaningful increase in Brazilian output over the next few years and we doubt any other producer will up their production to compensate. End-destination buyers are well aware of this so will price if we see prices drop below 22 cents.

**Weekly ICE SUG11 MAR2**

05/09/ Q10 - 29/01/ Q12 (NYC)

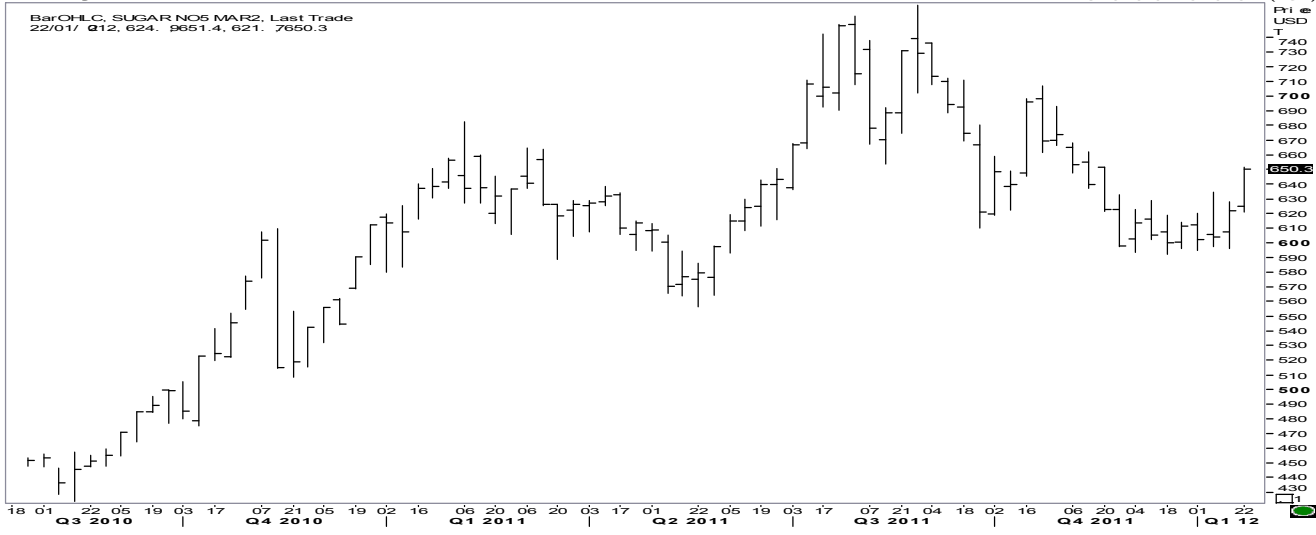
BarOHLC, I @ SUG11 MAR2, Last Trade  
22/01/ Q12, 23. 9, 24.98, 23. 8, 24.94



**Weekly SUGAR NO5 MAR2**

18/ 0/2010 - 29/ 0/2012 (LON)

BarOHLC, SUGAR NO5 MAR2, Last Trade  
22/01/ Q12, 624. 9651.4, 621. 7650.3



## Coffee

2011 was a year of large price moves in coffee but not any substantial change in the fundamental picture. New York prices hit multi-year highs in early March after a long and steep rally lasting some nine months. During this time prices increased by 230%. Since then prices have gradually dropped back with the odd fund/macro inspired jump hitting the year's low just before Christmas. Many traders, including ourselves, felt that prices above \$3.00 per lb were not justified with overall global coffee production seen to be above consumption. However, the bulls pointed to the limited availability of washed Arabica as the main reason for the strength with poor crops in Colombia and Central America the main reason. In the end the strength of the US dollar was the catalyst that sparked a sustained bout of long liquidation which eventually caused the funds to build a net short position. Fundamentally, we have not seen any huge jump in production although the weight of global coffee supplies eventually had an impact. A relatively benign Brazilian winter helped calm nerves and encouraged further long liquidation especially when the spring rains arrived in time. Since October the rains have been good. Therefore the 2012/13 Brazilian crop is likely to be huge – around 58 million bags is current thinking. A bout of cold weather in August and some dry weather in September has probably knocked off 2-3 million bags from the crops full potential. The largest Robusta producer, Vietnam, has enjoyed another good season with the current harvest likely to yield around 21 million bags. Apart from a drop in production in Indonesia Robusta farmers across the world have enjoyed good prices despite surplus supplies over the past year thanks mainly to the high Arabica price. Nevertheless the arbitrage between the two markets remains at record difference.

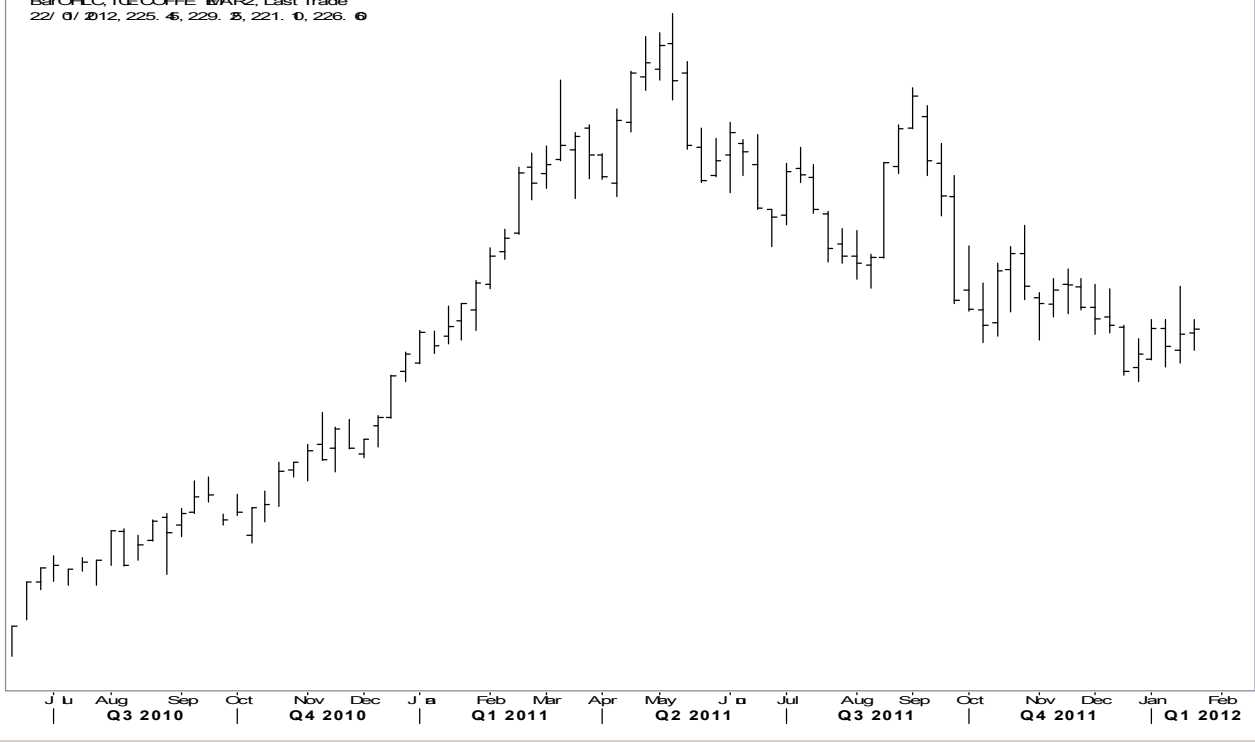
Looking forward into 2012 we see little reason for too much price movement as the fundamental picture stands at the moment. However, we are not naive enough to believe this will be the case. The funds, currently, short are likely to cover sometime which could produce a price spike. Undoubtedly the weather will cause some concerns at sometime during the coming year. Finally, the global macro economic picture is very likely to remain turbulent. The up-coming Brazilian crop is likely to be huge but this is, to a certain extent, priced into the market. We suspect that 2012 may well be the year when we see a sustained recovery in the Colombian crop after several years of appalling weather coupled with an intensive renovation programme that saw trees replaced and heavily pruned. This could be the one development that would send prices below \$2.00 per lb. currently the market looks well supported with strong demand as global consumption remains very buoyant despite the economic woes of the world. On the other hand the world is not short of coffee so unless a serious supply problem emerges in a major grower due to weather or some political reason we see the up-side potential as limited.

**Weekly ICE COFFEE MAR2**

13/ 6/ 2010 - 19/ 2/ 2012 (NYC)

BarOHL.C. ICECOFFE MAR2, Last Trade  
22/ 01/ 2012, 225. 45, 229. 25, 221. 00, 226. 00

Price  
US\$  
Lbs  
300  
290  
280  
270  
260  
250  
240  
230  
225  
220  
210  
200  
190  
180  
170  
160  
150  
140



**Weekly COFFEE NEW MAR2**

13/ 6/ 2010 - 19/ 2/ 2012 (LON)

BarOHL.C. COFFEE NEW MAR2, Last Trade  
22/ 01/ 2012, 1. 99, 1. 917, 1. 83, 1. 909

Price  
USD  
T  
2. 50  
2. 40  
2. 30  
2. 20  
2. 10  
2. 00  
1. 90  
1. 80  
1. 70  
1. 60  
1. 50  
1. 40  
1. 30  
1. 20  
1. 10  
1. 00



## COCOA SUMMARY

The Cocoa market has been able to sustain a recovery in prices into the New Year having been under significant pressure from an extended down-trend since the summer months.

Sustained selling pressure in the form of Origin hedging and speculative selling, overcame light to moderate Industry purchases into the recent sharp decline. A background of surplus overhanging stock from last season, good arrivals of current crop and the real prospects of an imminent resurrected Ivorian forward auction sales programme combined with bearish macro issues to extend the on-going downtrend. Industry off-take and forward cover purchases, not un-surprising, were light and limited within the declines. However, the market did succumb to a period of volatile consolidation, marked with a significant technical key reversal in mid-December, followed by aggressive volatile short covering inspired rallies. Principle factors to the rally would lie with a prospect of a sustained “Harmattan” wind possibly doing damage to the tail of the main and mid-crops. Combined with the seasonal decline of arrivals of main crop, immediate overhead hedging pressure was absorbed and significantly reduced.

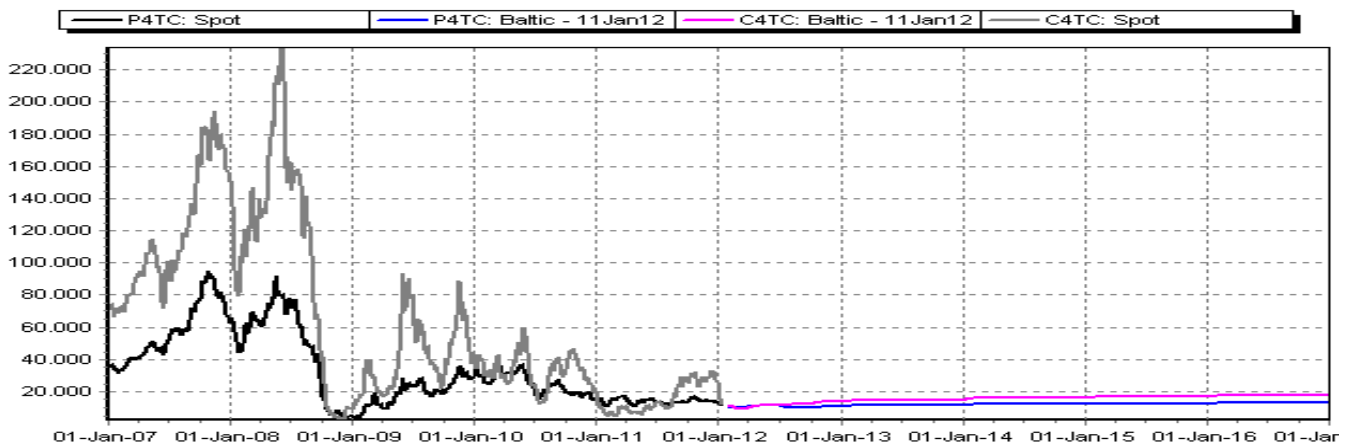
Unfortunately, the Cocoa fundamentals are somewhat muddled at this juncture. With a possible return to sporadic rains and increased humidity, Harmattan concerns may yet be abated? Coupled by the fact, that the rallies were fuelled principally by short-covering and not by new buying, suggests the rallies may not be constructive and may be vulnerable to set backs? Additionally, perceived Industry cover appears to be more than adequate at present levels and thereby less likely to feature. Indeed, without any confirmed significant crop damage, the market may yet struggle to sustain a rally in the face of suspected softer demand and perceived short –term over supply prospects?



Daily London 2nd month continuation

## Freight Review

The dry bulk market was relatively strong in the beginning of December with Cape as well as Panamax levels increasing steadily. Physical Cape levels have been supported by both congestion and weather delays as well as lower iron ore prices. The confidence in the Cape market was evident – at least for the short term – as Chinese iron ore demand continued to absorb tonnage. Panamax levels followed that trend as more coal was to be shipped out of Indonesia and generally more cargo came out of the US Gulf. On the back of the latter and the Cape market pushing, Panamax levels increased until reaching a high of USD 14.187,50. As the Chinese economy is expected to slow down, new housing starts in China were falling (requiring less iron ore than expected) and 2012 expected to be even more difficult than 2011 this trend did not continue towards the new year. After reaching a high of USD 32.888,75 mid-month Cape levels decreased more than USD 5.000 until Christmas. As more ballasters of the over-tonnaged east met a lack of fresh cargoes in both hemispheres Panamax levels also started a steady decrease. The FFA market was supported by the positive feeling of the physical market throughout the first half of December and the relatively high long term period charter rates in the Cape market also were suggestive of some confidence in the market, but soon the pre-holiday feeling arose and both trading activity and price levels slumped. Market Expectations for 2012 are relatively bleak with the oversupply of tonnage expected to be worsening and demand growth being limited compared to fleet expansion and rates already being low. Looking at the forward curve one does not see any support from the physical market any time soon.



The TC2\_37 increased throughout the whole month of December from WS 153,96 to WS 235,63 mainly due to LIFO (Last in, first out) barrels as they are moved out of the storage for the end of the year stock count onto ships. The general outlook here is depressed as Gasoline imports to the US are relatively low and imports are not expected to increase with current demand levels.