MARKET VISION

The Commodity Update

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Economic Outlook

Leading indicators were up 0.3% in August, following a 0.6% increase in July. But consumer spending was flat as income in August fell (by 0.1%) for the first time since October 2009. Consumer spending slowed sharply to a 0.7% pace in Q2 after advancing 2.1% in Q1. Consumer confidence edged up a bit to 45.4 in Sept, but that follows a 25% plunge to 45.2 in August.

The consensus of 53 economists surveyed by *The Wall St. Journal* in mid-Sept is for GDP to expand at less than a 2.5% rate for the rest of this year and for all of next, down from estimates near 3% just two months ago. They expect the economy to add just 125,000 jobs a month over the next year, barely enough to keep up with population growth. Job growth so far in 2010 has averaged just 109,000 per month. Economists now see a 1-in-3 chance that the U.S. will slip into recession over the next year.

Q2 residential investment was just 2.2% of GDP, the lowest since 1945. If it were just at its 1950-2000 average of 4.7%, GDP would be 2.5% higher. A survey of 100 economists by MacroMarkets showed home prices are expected to drop 2.5% this year and rise just 1.1% annually through 2015. The housing bust may continue to dampen consumer spending for years to come.

Fears of global eco slowdown, along with disappointment over the lack of stimulus from the Fed and Congress, led to a broad-based sell-off in both equities and commodities. This is the 3rd major sell-off this year. Since the beginning of Sept, corn futures have plunged from $7.57 to $6.05; soy-oil from $.58 to $.49; and coffee from $2.89 to $2.27. But fundamentals remain relatively bullish for proteins, particularly livestock futures, which moved higher over the same period. One positive for consumers: The price average of regular gasoline has dropped to $3.41 a gallon, down 15% since peaking in May near $4 a gallon.

Focus: Energy Conundrum

Q: How are oil-rich Middle-East monarchies responding to the “Arab Spring”?
A: Why, they’re smothering the populist sentiment under mountains of money. OPEC members are poised to rake in a record-high $1 trillion this year. And unlike past booms, when Abu Dhabi bought soccer club Manchester City and Qatar acquired a stake in Porsche, Gulf nations this year pledged $150B in additional spending on their own people. Kuwaiti citizens are getting free food for a year, and civil servants in Algeria got a 34% pay raise.

In Saudi Arabia, demonstrations failed to take off in March because of $43B in new spending directed at poorer citizens and religious institutions. 60,000 new jobs have been created at the interior ministry. Gov’t employees got a 15% salary increase and 2 months of extra pay. $267M has been allocated to the Saudi Ministry of Islamic Affairs to restore mosques and fund “guidance offices,” came after clerics backed a ban on domestic protests.

But now OPEC needs to keep oil prices above $80 to maintain the increased social spending. Costs of budget obligations have more than doubled since 2006 to $77 per barrel, with Saudi Arabia needing an average of $82, according to Deutsche Bank. At first blush, this may seem like more bad news for the west. OPEC tightens supplies and keeps prices higher. But there are several silver linings here. The first is that OPEC members in the past have always cheated on their production quotas whenever they needed extra cash, so we can expect the extra spending to be offset by extra cheating. This will help inflate OPEC output above set "targets."

More importantly, OPEC has put an almost guaranteed "floor" under oil prices that will help encourage investment in difficult or expensive drilling projects such as tar sands and deep sea, as well as alternate energies that compete with oil. For the past 50 years, every time the domestic energy industry got on a roll, the Saudis would open the taps and drown us with cheap oil. That may no longer be possible. Finally, U.S. producers may have an opportunity to explore for oil and drill without fear of price collapse.

Nowhere is the opportunity greater than in the Bakken oil fields of Montana and North Dakota. Private estimates put Bakken's reserves in excess of 20B barrels, almost twice as big as the oil reserve in Prudhoe Bay, Alaska. If those estimates prove correct, it will double America's proven oil reserves. New techniques in deep and horizontal drilling (2 miles down), plus $80 per-barrel prices now, make reserves like Bakken accessible and profitable.

When OPEC was at its peak in the 1990s, the U.S. imported about two-thirds of its oil. Now we import less than half of it, and about 40% of those imports come from Mexico and Canada. But rather than taking advantage of this opportunity to bury OPEC as an influential supplier to the U.S., we have instead chased "green" pipe dreams. Disappointments in alternative fuels just keep piling up; from ethanol's false promises to the recent $500M lost gov't investment in solar energy producer Solyndra. And, China has beaten the U.S. to the punch in developing both solar and wind technologies, rendering a number of our investments uncompetitive.

Meanwhile, oil and natural gas reserves hold out the potential not just for greater energy independence from OPEC, but also for the opportunity to keep jobs and, more importantly, billions in taxes within U.S. borders. Those revenues could help fund alternate fuel research and provide some much needed federal and state tax revenue. Yes, oil and gas producers are unpopular and at times environmentally abusive. But they have continued to progress despite government roadblocks.

Perhaps those who oppose continued development in fossil fuels should set the example for the rest of us by giving up their use of fossil fuels. Let's start with Congress and the White House. Since they are hell-bent on sending us back to the Dark Ages, let them live that way for a while. A month of no driving, cooking, lights, heat or AC should be enough to convince anyone that we can't just abandon that which we so critically depend on, even if those industries aren't the most popular or "politically correct."

▸ Beef

The USDA reported 9/1 cattle feedlot inventories at 10.7M head, up 5% from a year ago. But new feedlot placements in August were less than expected, at 1% below year-ago levels. One of the largest drought-based herd liquidations ever may finally be starting to run its course. Ranchers will slaughter 500,000 beef cows normally kept for breeding, sharply reducing producers' ability to expand herds in future years.

Meanwhile, world markets remain red hot. U.S. beef exports totaled 1.6B lbs in Jan-July 2011, up 27% from a year ago. A pending new trade bill with South Korea could give a big boost to an already growing market. Cattle futures hit a record-high $123.10 on 10/3, and closed at $122.80 on 10/5. 2012 contracts are trading in the $123-126 range, reflecting expectations for even higher beef/cattle prices through next year. Long-term fundamentals point to even higher beef/cattle prices through 2012 and 2013 at the very least.

Choice quotes as of 10/5: #174 XT (0x1) short loins @ $4.44, down $.09 from last month, will hit a low in the $4.10-$4.20 range this month and will then start heading higher: $4.30 in Nov, $4.60 in Dec. #180 XT boneless strips @ $4.32, down $.24, are at or near a bottom and headed to near $5 by year's end. #184 XT top butts @ $2.50 are down $1.82 and will trend higher.

#112A choice rib-eyes @ $6.42 (up $.87) should peak around $6.55 in Nov. #189A choice tenderloin @ $9.73 (up $1.41) will be $10.50 or better in Nov-Dec. #193 flank at $4.72, down $.14, should fade to below $4 for Nov-Dec. #168 XT top rounds @ $2.13 (up a penny) look to average about $2.05 for Q4.

Select quotes as of 10/5: #174 XT short loins @ $3.65 are down $.49 from a month ago and are headed for a low of $3.30 in late Oct before bouncing back to $4 in Dec. #180 XT boneless strips @ $3.52 (down $1.04) will bottom near $3.30 in Nov before moving back toward $4 by year's end. #184 XT top butts @ $2.16

(down $.14) look stable through Nov, higher in Dec. Select #112A ribeyes at $4.66 (up $.20) should peak near $5.50 in Nov. #189A tenderloin @ $8.10 (up $.06) are headed for an $8.80 high in Nov. Cap/wedge meat @ $2.37 (up $.04) should trade near $2.30 through year's end. Domestic 90s trimmings @ $1.66 (down $.13) will dip to a low of $1.60 in Nov before turning higher in Dec. Beef 50s fat trimmings at $.90 (up $.02) should average in the low-$.80s for Q4.

▸ Coffee

Futures prices plummeted from a high of $2.90 on 9/1 to $2.23 on 10/3 and closed at $2.2590 on 10/5 as investors liquidated positions in the face of dismal global economic forecasts. Coffee crops in Brazil are expected to begin flowering in October, and rainfall, which has been sparse, is critical to that process. Brazil's 2011/12 crop is projected to be 46-47M bags, record-large for an "off" season. High prices have encouraged growers in Brazil to plant more trees and increase productivity. The 2012/13 crop could be record-high as well, in the 57-60M-bag range.

Elsewhere, Mexico and most Central American countries expect production recoveries this year. Colombia's flood-reduced 2010/11 crop at 8.7M bags should recover to roughly 10M bags, but remain below the 12.5M level of recent years. Coffee futures are now getting closer to that $2.00-2.25 range that we were expecting for Q4. It remains to be seen how heavy roaster buying will be at current levels, which could put a floor under prices for a while.

▸ Dairy

It's been a steady march lower for dairy prices over the past 2 months. CME block cheese prices began August at $2.14 and finished Sept at $1.72. Butter dropped from $2.09 to $1.76 in just the month of Sept. The biggest change over that period has been in export markets. Oceania butter has dropped to $1.86 and is not supportive of U.S. exports. Oceania cheddar at $1.94 is supportive of cheese, but the demand is just not what it was in the 1st half of the year.

On the production side, Aug cheese output was 1.15% above a year ago. Aug butter output at 133M lbs was 4.8%, or 9M lbs, above year-ago levels. The USDA is forecasting milk production to be up 1.5% in both 2011 and 2012. The recent drop in corn prices, if it holds, adds profitability and the potential for additional output (above current USDA projections) for 2012. Going forward, retail promotions for the fall holidays will likely have some effect on prices (so expect some up-down price movement), but the general trend will be one of lackluster retail demand and weaker prices.

▸ Grain

In Sept's World Agricultural Supply and Demand Estimates (WASDE), the USDA cut its corn forecast and has now lowered corn yield from 157 to 153 and now just 148.1 bushels per acre. However, last week the USDA's statistics division (NASS) reported corn inventories at a much higher-than-expected 1.128B bushels, 23% above the USDA's early Sept WASDE report. Corn futures plummeted from $7.63 in late August to a low of $5.87 on 10/4 and then rebounded to $6.05 on 10/5. Forward contracts for 2012 are trading in the $5.73-6.30 range, about $1.50 lower than a month ago.

But let's not forget that China's appetite for U.S. corn has put a floor under the market in 2 previous sell-offs this year. Despite efforts toward self-sufficiency, surging demand for meat and eggs are outpacing domestic corn production. The U.S. Grains Council estimated that China may need between 5-10M metric tons before the end of 2012 to replenish corn inventories.

The USDA also reported that wheat stocks were larger than expected at 2.15B bushels. With corn prices as high as they have been, analysts expected livestock producers to shift from feeding corn to feeding more wheat, but feed usage declined by 50M bushels this summer. The drought in TX and OK has abated a bit, but not nearly enough to save this year's winter wheat crop. CBOT wheat futures have dropped from $7.62 in late August to a low of $6.04 on 10/4 before rebounding to $6.25 on 10/5. Forward contracts for 2012 are trading in the $6.60-7.37 range. KCBT (hard winter) wheat futures have dropped from $8.74 to $6.99 and are trading in the $7.15-7.67 range for next year.

▸ Oil

Soy-oil futures have dropped along with other commodities, and bearish global fundamentals could push prices even lower in Q4. Russia's sunflower seed output will be record-large this year, pressuring prices for both soy-oil and palm oil worldwide. Palm oil output (currently at a seasonal peak) may get to 19M tons this year in Malaysia, up 9% from a year ago, while Indonesian production looks to be a healthy 25.5M tons. As a result, palm oil's discount to soy-oil was $211/ton on 10/4. That compares with an average of $164/ton this year, according to Bloomberg. U.S. palm oil imports should rise next year due to this widening price gap.

Domestic use of soybean oil for 2011/12 is forecast to rise from 16.60B to 17.75B lbs. Nearly all of the increase is in biodiesel. Soy-oil used for biodiesel will expand from 2.4B to 3.6B lbs in 2011/12. But a huge (Canadian) canola supply should offset any domestic soy-oil headed to biodiesel. Soy-oil futures, which were $.58 as recently as 9/7, dropped to $.49 by 10/5. Surging global consumption of fats and vegetable oils could still exceed output in 2011/12, keeping stocks-to-usage ratios at multiyear lows and continuing to support prices in 2012.

▸ Pork

Last week's USDA Quarterly Hogs & Pigs report showed larger-than-expected numbers in almost every category. The June-Aug pig crop at 29.084M head is up 0.7% from a year ago, while the June-Aug litter size of 10.03 pigs-per-litter was 2.2% larger than last year. While supplies will be up a bit more than expected, strong exports sales have helped hog futures rebound from a bottom of $83.35 on 9/6 to $93.67 on 10/5.

Traders are widely expecting increased exports to China and a pending trade agreement with South Korea to continue to support demand through 2012. Total exports through July are running 16.6% above a year ago. Exports to South Korea are up 129.4%. Exports to China are 248% above year-ago levels, but have fallen off substantially since April.

Prices as of 10/5: 20-23# ham prices at $.94/lb, up $.06 from a month ago, are already at or near a seasonal high. Retail-sized 17-20# hams at $.94 should gain a few more cents ahead of Thanksgiving. Pork bellies at $1.22 are up $.12. Bellies are higher than expected for this time of year and are likely to trade closer to $1.00 in Q4. Loin back ribs are at $2.78, down $.38 from a month ago, and should drop to $2.60 in Dec. 42% pork trimmings @ $.77 and 72% trimmings at $.97 are both down a penny from last month. Look for trimming prices to fade through year's end.

▸ Poultry

Cold storage chicken supplies fell 7% to 702.2M lbs in August and are now slightly below year-ago levels. The USDA has tried to help by buying an extra $86M for gov't programs in 2010/11, and said in August it would buy an extra $40M for soup kitchens and school lunch programs. But chicken producers are still struggling with high inventories, heavy bird weight, high feed costs and low chicken parts prices. Breast meat in cold storage on 9/1 was 47% above a year ago, while leg quarters were 9.7% higher than in 2010 and 53.5% above the 5-yr average. This inventory should get worked off in Q4. Egg sets were 8.2% less than a year ago for the month of Sept, and chicks placed were 5.1% lower, while weights averaged 2.7% above last year. Production in Q3 was down 1% vs. Q3 2010, and Q4 is forecast to be 3% lower than a year ago.

Prices as of 10/5: Breast prices took another tumble in Sept to $1.22, down $.14 from a month ago. Cold storage supplies are falling, albeit slowly. We still think BS breast prices will get to $1.40, but not until 2012. Look for prices to drop further in Oct before rebounding to $1.30 in Dec. Wings at $1.18 are up $.23 and headed to the $1.30s (pre-Super Bowl) in late Jan. Leg quarters have peaked at $.52, down $.02, and look to be in the mid-$.40s by Dec.

▸ Produce

The fall lettuce crop will move from Salinas to Huron, CA, in mid-Oct and will stay there for 3-4 weeks before transitioning to Yuma, AZ, in Nov. As is typical in the fall, chances are higher than usual for both price and quality volatility, especially if the weather causes any supply gaps or overlaps. Prices as of 10/05:

Avocados – MX Hass 2-layer cartons 32s 31.75; 36s $34.75; 40s $37.75; 48s $27.75; 60s $21.75; 70s $20.25.

Broccoli – CA cartons bunched 14s $7.50.

Lettuce – CA Iceberg cartons 24s $6.98; Romaine ctns 24s $10.68; Boston 24s $7.00; Green Leaf $7.50; Red Leaf $6.40.

Onions – WA Yellow Hybrid 50# sacks colossal $6.25; jumbo $5.00; medium $5.25.

Peppers – CA Bell green 1/9 bushel cartons large $10.50; medium $9.45.

Potatoes – ID U.S. Russet Burbank 5# "A" 50s-60s $10.50; 70s-80s $9.50; 90s $8.50; 100s $7.25.

Strawberries – CA 12 1-pt containers sm-med $10.50.

Tomatoes – CA 25# cartons loose Mature Greens 5x6 $7.95; 6x6 $8.45; 6x7 $9.45.

Freight – CA truck quotes as of 10/05/11: Atlanta $6,300; Chicago $5100; NY $7,400.