MARKETS

After the big drought

BY PHILIP BURGERT

The growing season may be over, but questions abound about the future of the grain and livestock sectors as the harvest wraps up and next year approaches.

The U.S. drought of 2012 drove corn and soybeans to record or near-record prices this year, but the full impact of the summer's heat wave and drought on grain and livestock markets is still to be determined, say farmers, traders and analysts.

Soybean prices in particular backed off from highs after farmers started reporting better-than-expected yields, and corn retreated when high costs cut forecasts of demand. But carryover stockpile calculations and forecasts of yields and harvest acreage continued to provide plenty of questions going into the fall, analysts say.

The questions also increased speculation and predictions about the outlook for cattle, hogs and poultry, which consume much of the grain supply and could face sharp rationing of production in the next few months.

"It's really a question of fine-tuning supply and trying to figure out which demand category is going to get rationed and how much," says Dan Cekander, director of grain research for Newedge USA. "Certainly we're going to have to cut back on corn feeding significantly. Obviously it looks like we're going to cut the exports back significantly."

The scale of the problem is highlighted by Tommy Kent Crouch of TKC Investment Services (see October 2012 Trader Profile) who calls the drought the worst of his 46-year trading career. "This is a catastrophe of Biblical proportions," he says. "You go from Pennsylvania all the way to Colorado, [all] were in the grips of a tremendous drought, tremendous heat. It affected a very, very wide area of this country."

But Crouch says his initial predictions of the impact of the drought on soybean yields were proven wrong in mid-September when he realized that his mother's soybeans, contracted at 40 bushels per acre, actually were going to come in well above that figure and eventually were harvested at 68 bushels per acre.

"That shocked me to no end," he says. "This bean crop is better than even the old pros like me thought it was. The crop scouts had missed it." Crouch says he

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had gotten out of the market and even gone short on soybeans (see "Broken beanstalk" right) and corn. "I don't know whether the beans are worth $14 or $18. It will all shake itself out in the next 30 to 45 days. But there is a fundamental that you can think you know, and you actually can be wrong."

Crouch adds that he is not wrong on corn, however, and that the crop is very short. "I still maintain that the crop will be under 120 bushels per acre," he says. "I'm rather sure of that. The big jump ball here is what the government is going to do with planted acres and what they are going to do with harvested acres. None of us know that.

"I wouldn't be surprised for them to use some creative accounting to raise planted acres and not change harvested acres too much, so they will have what they call pipeline carryover. But the corn crop is short, and I mean really short," Crouch says. The complete scope of the drought's impact on grains is not likely to become clear before supply and demand reports are issued in January, he says (see “Bad numbers,” right).

Because corn is crucial to raising livestock, including poultry, hogs and cattle, feeding margins will be lowered sharply by the higher prices and animal numbers will be cut. “We probably have too much killing capacity for the number of cattle that we’re going to have,” Crouch says. “I tell my city friends a year from now when you order a steak, you’ll think you’re eating lobster. It’s going to be high priced. We’re going to have reasonably priced meat here for another 90 to120 days as we liquidate some of this breeding stock and put the extra meat on the market (see “Eat more chicken,” page 14). But once that is done, protein in this country is going to be very, very high.”

J. Richard Crow, president, owner and principal of Crow Trading Inc., says the grain and livestock market outlooks will be contingent on supply and demand calculations, crop reports and stock reports. “Stock reports are hard to measure and this is an extremely tough one to measure,” he says. “You’re not going to know the feeding deal until you get to the January report and maybe clear out into the March report. So the market’s going to be off-base on feeding and residual all year, or has the chance to be off-base all year.”

Malinda Goldsmith, a principal of Four Seasons Commodities Corp., says she also is expecting further revisions in numbers. “We actually think the corn yield is going to come down a little more from the USDA [estimates], and that the harvested acres are going to come down as well in corn particularly,” she says.

Higher soybean yields also portend increased results in future reports that already are being priced into bean futures, Goldsmith says, adding that she is waiting to see the size of the crop. “Once that is defined, we will be watching to see how demand develops. We expect tightness in available supplies after the first of the year.”

Nick Leblebijian, principal and managing member of Ceres Funds, says he believes the market has been capitulating recently and will find a bottom to move higher. “This recent selloff is not a surprise,” he says. There was “a huge runoff and now you’re into harvest. As everyone knows, you have harvest pressure. I don’t believe we’ll continue lower.”

Also contributing to uncertainty is the demand outlook for corn used in ethanol. “At $7.50-$8 corn, ethanol doesn’t really make sense,” Leblebijian says, while adding that calculations of the number of ethanol plants shut down by the drought, dropping crude oil prices and abundant natural gas availability, all make it difficult for ethanol to be profitable with high corn prices.

BROKEN BEANSTALK

November beans climbed all summer as the drought worsened but have dropped nearly $3 as yields were better than initially feared.

Source: eSignal

BAD NUMBERS

All the numbers are not in, but this year’s corn crop will be the worst in many years and ending stocks will be at record lows. Newedge’s estimate is a little more pessimistic than that of the USDA.

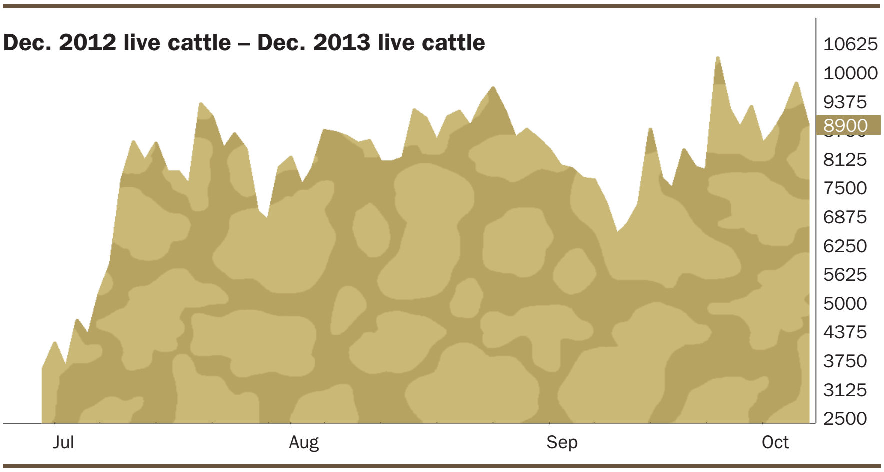
US corn supply/demand balance (Sept. 2012 – Aug. 2013) *(million/bushels)*

	08-09	09-10	10-11	SEPT USDA 11-12	Newedge 11-12	USDA 12-13	Newedge 12-13	Newedge 13-14
Planted acres	86.0	86.4	88.2	91.9	91.9	96.4	97.0	96.0
Harvested acres	78.6	79.5	81.4	84.0	84.0	87.4	87.1	89.0
Difference	7.4	6.9	6.8	7.9	7.9	9.0	9.9	7.0
Yield	153.9	164.7	152.8	147.2	147.2	122.8	122.6	162.0
Sept. 1 stocks	1,624	1,673	1,708	1,128	1,128	1,181	988	528
Production	**12,092**	**13,092**	**12,447**	**12,358**	**12,358**	**10,727**	**10,670**	**14,418**
Imports	14	8	28	25	25	75	70	25
TOTAL SUPPLY	13,729	14,774	14,182	13,511	13,511	11,983	11,728	14,971
Feed	5,182	5,125	4,793	4,400	4,588	4,150	4,100	5,200
F/S/I	5,025	5,961	6,428	6,390	6,393	5,850	6,000	6,425
Ethanol for fuel	3,709	4,591	5,021	5,000	5,003	4,500	4,650	5,000
Exports	1,849	1,980	1,834	1,540	1,542	1,250	1,100	1,800
TOTAL USAGE	12,056	13,066	13,055	12,330	12,523	11,250	11,200	13,425
ENDING STOCKS	1,673	1,708	1,128	1,181	988	733	528	1,546
Stocks/Use ratio	13.9%	13.1%	8.6%	9.6%	7.9%	6.5%	4.7%	11.5%
Farm price ($/bushel)	4.06	3.55	5.18	6.25	6.25	7.90	8.10	5.50

Source: USDA, Newedge

EAT MORE CHICKEN

As the drought kicked in, the premium built into further out cattle grew as ranchers found it hard to feed animals, creating a potential shortfall in 2013. The premium in Dec. '12 – Dec. '13 live cattle spreads grew to 10¢.



Source: eSignal

Cekander notes that the recent break in corn prices has helped sustain very small margins for ethanol production. Recent U.S. government forecasts of 4.5 billion bushels of corn grind for ethanol are minimal and the industry would like them to be close to 4.7 billion bushels, Cekander says. "We certainly would like to get the E15 [grade of ethanol] going, and that looks like it is going to be slow to be implemented at the retail level actually."

Ethanol now accounts for 10% of gasoline demand, or 13.2 billion gallons, and has hit a "blend wall," Cekander says. Adding 5% with E15 will result in small quantities this year, 300-400 million gallons next year and will continue to expand beyond that, he adds. Traders note that depending on the quality of the corn, there are 3.2 to 3.8 gallons of ethanol in every bushel.

Another major factor in the grain outlook now is the impact that the drought and high prices have had on export markets for grains, says Cekander. He notes that Ukraine has had big production for two years in a row and that high-priced U.S. corn means that major traditional customers, such as Japan, are driven to them as alternative and cheaper feed sources.

"Of course, now their focus is on Brazilian corn, which is $40-$50 a ton cheaper than the United States," he says. "So that's a very negative development longer term for U.S. corn demand because now they've done it, they see how the logistics work, they've become more familiar with it and it's easier to do. So that alternative cheaper source becomes a problem for U.S. corn export from now on."

Jack Marshall, president and CEO of Paramount Capital Management, believes there will be a very large increase in planting of Southern Hemisphere and Eastern European acres as a result of the drought because of the extremely elevated price of grains. "To take advantage of it, they're going to put as many new acres in as they can. Nothing cures high prices like high prices."

Government numbers also show that there is far more demand than supply for corn, Marshall notes. "So the market is going to have to ration whatever's available and we're going to have to ration via the ethanol and livestock markets. It looks to me like you're going to have a pretty significant liquidation of cattle and poultry. We've already seen the beginning of it in hogs," he says.

The prospect of droughts continuing into the next growing season — or not — is another issue that traders will need to assess. "Weather is still an issue over in your hard red winter wheat area," Crow says. "It's a growing issue. We keep getting promises of rain, but we're not getting it and the question in my mind is, 'Are we getting the seed bed we really want or need?'"

A wheat market with a tight supply is going to require a good crop next year around the world. "You're not going to have room to have many major problems anywhere," Crow says. "We'll need a big crop and we've got to plant a lot of wheat acres across the United States. Soft wheat acres are going to be up, but hard wheat acres probably won't because we've already planted."

While corn and soybeans have had pricing pullbacks, the wheat market basically has stayed sideways, Leblebijian notes. "Chicago wheat basis December has traded between $8.50 and $9.50 most of the summer," he notes. "That also will see another run up. With this wheat market, if demand picks up globally, there is a lot of wheat, but I like the long side of wheat."

Leblebijian also sees corn in the short-term dropping below $7 and on the upside trading as high as $8. "November beans? Anything close to $15 would be a good buy, and [we could] see trading back to about $16.50, maybe even $17," he says. For December cattle Leblebijian likes the $124 range "per lot" and says that below that level he is a buyer. On the upside, "We can see $1.30 relatively quickly for Dec. cattle," he adds.

Cekander adds that at some point, however, a good global growing season — which in his opinion hasn't been seen since 2003 — could create some bearish scenarios for grains and livestock. "High prices brings acreage response around the globe," he says. "If you ever get that good growing season and you have big crops elsewhere in addition to here — and you have all this U.S. export competition and now the users are used to buying from alternative suppliers — you can get fairly bearish outlooks at some point."

On the other hand, he says, "Our demand is so big that we really depend on most of the world's crop areas to have a good crop to have enough supply."

What appears clear is that the 2012 drought is a multi-year story, of which we still don't know the end. Cekander concludes, "You can have some big moves in both directions over the next several years. They're going to be interesting markets." F