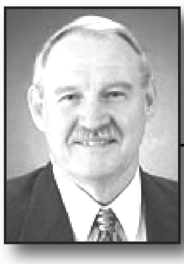
Rapidly Changing Crop Markets



grain outlook

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Last week there began to be some discussion about the end to the higher price trend in corn and soybean prices. Ironically, that discussion was followed by a move to new contract highs in both markets.

A number of factors unfolding over the past two weeks suggested that the increase in corn and soybean prices that began last fall might be coming to an end. The USDA's announcement of haying and grazing provisions for a large number of Conservation Reserve Program (CRP) acres suggested to some that there would be a significant decline in feed grain demand in the last half of 2008. Declining crude oil prices and the general world wide assault on biofuels production also signaled a potential decline in corn and vegetable oil demand. Suggestions that the U.S. government might take steps to defend the value of the U.S. dollar were viewed as potentially negative for export demand for U.S. crops. The sharp decline in wheat prices that made wheat competitive as a feed grain also pointed to a weakening demand for U.S. corn. The announcement by the Commodity Futures Trading Commission relative to the withdrawal of proposals to increase speculative position limits and to expand hedge exemptions was thought to signal a bursting of the speculative bubble in crop prices, even though credible evidence of a speculative bubble was lacking.

What changed? Two developments last week dramatically altered the fundamental situation for corn and soybeans. One was the reversal in crude oil prices. After declining by more than $10 per barrel, crude oil prices rebounded to new highs on June 6. The reversal followed from forecasts of continued upward pressure on prices into the summer months. Sustained high crude oil and gasoline prices would likely keep ethanol prices moving higher and support corn demand.

The second factor was the widespread heavy precipitation in major corn and soybean producing areas. The ongoing wet weather means further delays in the completion of planting. It now appears likely that not all of the acres intended for corn and soybean production will get planted or re-planted. At a minimum, significant acreage will be planted well beyond the optimum window for obtaining maximum yields. Whether from smaller planted acreage, smaller harvested acreage, or reduced yields expectations about corn and soybean crop size are being scaled back. With trend yields, the USDA has already forecast a sharp reduction in U.S. corn inventories by the end of the 2008-09 marketing year and the continuation of very tight soybean inventories. If production falls short of expectations, further reductions in corn consumption and rationing of soybean consumption would be required.

The USDA will release updated projections of supply and use for the current and upcoming marketing years on June 10. Those updates may contain some revisions in the projected level of consumption during the current marketing year. Soybean exports are progressing at a more rapid pace than projected, while corn exports have slowed. The most interest, however, will be focused on any adjustments in the average yield projections for 2008 and the implications for inventories at the end of the 2008-09 marketing year.

Potential crop size may continue to dominate the movement in corn and soybean prices over the next several weeks. Ultimately, however, the strength of demand for these crops will be most important as demand will determine the level of price needed to ration production. Consumption rates will be closely monitored for signs of a slowdown in use.

The widespread concern about food price inflation leads to questions about the potential for market intervention if crop prices remain high or move higher. Some intervention occurred earlier as a number of countries adapted policies to restrict exports or encourage imports in the face of high prices. U.S. export restrictions are highly unlikely, but other policy measures could be considered in extreme circumstances. There are two obvious measures that could have significance. One is additional CRP initiatives to increase the availability of forage or to expand crop acreage for harvest in 2009. The second is a restriction on biofuels production. Reducing or eliminating biofuels mandates has been proposed, but mandates are not currently the driving force in biofuels production. Production is motivated by gasoline prices and blender tax credits.

Uncertainty about crop production, demand strength, and potential policy changes suggest that significant price risk will persist into the heart of the corn and soybean growing season. Δ