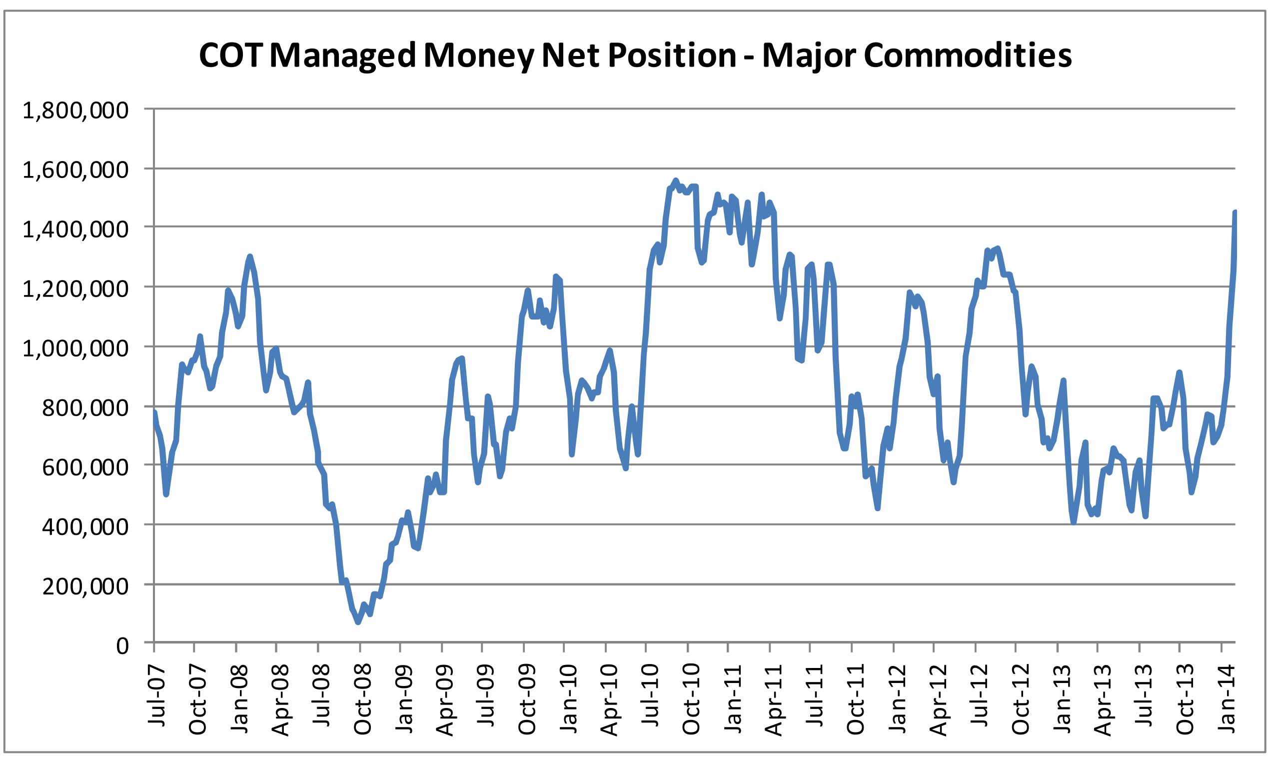
February 2014 Month End Comments

The month of February turned out to be very negative for our positions. We entered the month with short positions in corn and soybeans, and both markets instead churned steadily higher throughout the month. We scaled back on positions as the month progressed, but the damage was done and we are now staring at YTD losses.

Rather than run away from the past month, I think it's important to review where I messed up in my analysis. In my estimation, there are two major factors that I missed that should have alerted me to the price action potential.

The first item is fairly generic, but the flow of managed money into commodities this year has been much larger than I expected. In 2013, commodities were a largely forgotten "asset class," with equities working higher and higher. This year, even as equities continue to work higher, commodities appear to be catching more attention and the fund inflows have been impressive. The attached chart shows the CFTC's Commitment of Traders managed money net position in 18 major commodities. The markets included in this chart are cocoa, corn, crude oil, cotton, gold, copper, heating oil, gasoline, coffee, cattle, hogs, sugar, silver, soybeans, soybean meal, soybean oil, wheat, and natural gas. The surge in buying since the end of last year has been dramatic to say the least. Some of this buying has been spurred by intriguing fundamental stories in other markets, such as the Brazilian drought for coffee and the excessively cold conditions for natural gas. Still, this surge in interest in commodities should have set off alarm bells.



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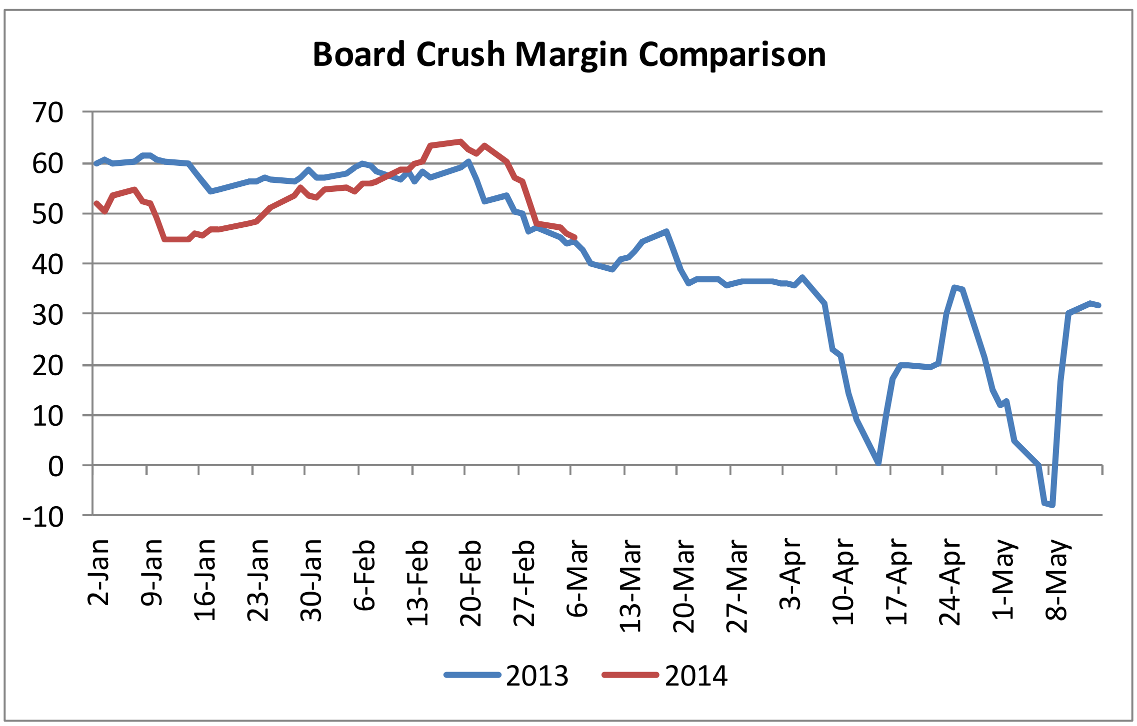
The other item that I should have paid more attention to is corn end-user margins. Margins on everything from corn feeding to ethanol production are nothing short of stellar…even after this (ongoing) rally. Simply put, there is no financial disincentive to continue to buy more and more corn at these levels from the end-user perspective. That should have been a signal that the rally had further upside potential than I originally thought. My short positions were focused in the new crop CZ'14 position, as I did anticipate a chance for old crop values to appreciate. I missed the upside potential in old crop values but more importantly the fact that new crop values would rally in sympathy in order to keep an appropriate carry in the market.

I'm certainly glad to have February behind me, and the lessons learned (and there are others besides those mentioned here) won't soon be forgotten. Despite the rough start to this year, I'm still optimistic on our positions going forward.

I believe soybean crush margins need to be squeezed considerably. With that in mind, I am long soybeans and short the products. Soybean export commitments are out of control and mostly in the line-up, meaning large scale cancellations are looking less and less likely. This leaves crush demand as the lone sector that will have to take the brunt of the demand-rationing effort by the soybean market for the second half of the marketing year. This is not all that different from the situation seen last year, where crush margins were squeezed to near zero in the spring. I think I can make an argument that this year's situation is even worse considering the unbelievable amount of export commitments on the books right now. The soybean market has little choice but to choke off any "extra" crush demand from developing for the remainder of the marketing year. The board crush margin is still at a lofty level and this won't discourage crush. Cash crush margins are even fatter, meaning the market still has a lot of work to do.



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I still feel negatively towards new crop corn values, but the market is telling me it is too early to establish a meaningful position here. The cold winter weather appears likely to linger well into March and perhaps beyond. This will keep soil temperatures cool and will increase concerns about a slow planting pace later this spring. While I typically find that concerns during planting season are overblown, I have no interested in stepping in front of that possible concern right now. I still assume "normal" weather this summer, and with adequate acreage the corn balance sheet should show further expansion in inventories in new crop. I remain negative, but am waiting for a better time to develop a position.

The balance sheets tell me to be negative to wheat, but there is entirely too much risk in this market right now. I think the HRW-SRW spread is over-extended and would look for new crop SRW futures to gain vs. HRW in the weeks and months ahead. That said, there is so much uncertainly about weather in the US and FSU. This along with all the confusion surrounding current events in Ukraine makes this market entirely too difficult to predict, and for now I'll watch from the sidelines until there is a bit more clarity.

I was long the hog market for a short stretch, but bailed on that position apparently too soon. My thought process was to expect a substantial rally in hog prices for the summer months, and the sudden rally recently took me a little by surprise. As I thought the market was reacting a bit too soon relative to the fundamentals, I exited the position. Unfortunately, the market has continued to chug higher, and I'm on the sidelines watching. I won't chase the market higher here.

It hasn't been the start to 2014 that I anticipated, but I look forward to the opportunities and challenges ahead.

Thank you,
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March 6, 2014

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