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August 2013 Month End Comments

Earlier this month my colleagues and I conducted our annual Corn Belt crop tour. Over the course of eight days, we traveled just under 3,000 miles reviewing corn and soybean conditions across the key production states of Illinois, Iowa, Minnesota, South Dakota, and Nebraska. The objective yield samples taken were compared against our database from previous trips, which dates back to 2005.

Generally speaking, here are some broad assessments from the data collected on the trip:

- Ear counts were up across most areas in the Corn Belt we traveled. There are certain areas that saw declines but overall there is certainly a trend for higher populations.
- Rows of kernels, while certainly stronger than last year in most cases, were not as strong as I might have expected before the trip. Wet conditions could have hurt the crop's early development, which is when the plant decides how many rows of kernels to develop.
- The length of grain was also no better than average in most cases. There were areas with very good ear length and others with short and tipped-back ears. Most will point towards the dry conditions as a key catalyst for the tipped-back ears, but I would note that the higher plant populations are also a major factor.
- Soybean pod counts were below average in most locations around the Corn Belt. That, of course, doesn't mean final pod counts will be below average when the crop is finished, but with the late development of the crop it was hard to get a good read on potential.
- In instances where we sampled plants that seemed to have maxed-out on their pod potential, the one disconcerting factor that we noticed in a lot of locations was that the number of beans/pod seemed light relative to our historical data.

Upon returning from the trip and analyzing the numbers, I established a national average corn yield "potential" of 157.0 bpa and a national average yield "potential" in soybeans of 42.3 bpa. If these production levels were to be realized, I believe it would be incredibly negative to price direction.

However, the weather during the month of August did not cooperate. A major factor in development of those crop potential levels is an assumption of "normal" weather going forward. Instead, during the month of August rainfall was well below average in most areas of the Corn Belt and temps were extremely hot in the last week of August. In corn, this has likely pushed the crop's maturity faster than the plants would prefer, which usually results in a yield drag. In soybeans, where August weather is usually the most important determining factor in yield potential, this weather could be even more problematic. Last year's bean yield was saved by late-August showers that allowed for pods to pack on extra weight. This year, it just doesn't look like any significant rainfall is in the making. The soybean plants have likely decided not to produce any additional pods and in a lot of cases have aborted some of their previously-established pods. This, combined with the above-referenced fact that beans/pod counts were looking light makes a situation where the bean yield is extremely difficult to guess…but we know it is getting smaller.

Considering the poor August weather and the likelihood of continued below-normal rainfall, I've decided to "stress test" my yield assumptions. Under this stress test analysis I produce a national average corn yield of 154.2 bpa. Note that I'm not really trying to figure out what the final production number will be, but rather I'm more interested in comparing my thoughts with what the market is pricing in. Currently, I think the market is underestimating corn production potential and as such I still remain negative to corn prices.

In soybeans my "stress test" results in a national average yield of 41.0 bpa. That is significantly higher than most other analysts (many of whom I have great respect for) are suggesting at the moment. Predicting the soybean yield is always a good way to look foolish. It is a resilient plant that can pack on bushels at the last second, but it can also trick you into false hope for potential. I honestly feel the market is getting carried away with their dire predictions for the soybean crop, but I concede that my confidence is low considering the poor conditions over the past month (and longer in some parts of the country).

I continue to expect downside price action in the corn market in the long term. As noted above, my estimated range for national average corn yield is roughly 154-157 bpa. If production were to come anywhere in that range, it would imply a more than amply supplied corn balance sheet for the 13/14 marketing year. Combine the improved production with a relatively poor demand base (GCAU numbers steady, ethanol demand likely steady, and still strong global competition for exports) and even with reductions to production versus prior expectations, the corn balance sheet appears to have no reason for concern. South American corn production this winter is very likely to decline from last year's record levels, but this should still support an ample exportable surplus that the US will have to compete against.

I am very cautiously friendly to soybean prices in the near term, but my long term thoughts are more mixed. As noted in the discussion above, there is still a great deal of debate surrounding soybean production, and the truth is we just won't know what production is until the combines start rolling. I am concerned that over the next few weeks as private production estimates are rolled out ahead of the USDA Crop Production report, the market will start to price in lower production and start to "mentally" tighten the 13/14 balance sheet. While I suspect the market might be getting a little too aggressive to the downside, I cannot discount the fact that the weather has been problematic (to say the least) and yields are getting smaller from some level. With that in mind, I do have a very small net long position in soybeans at the moment.

The fall timeframe is a very tough period for grain market bulls. Regardless of whether you've got a "big" or "small" crop, the fall is when harvest kicks in and it is the most amply-supplied period of the year… even in years of poor crops. The cash market for both corn and soybeans remains inverted, meaning the farmer will likely sell aggressively until that inverse works away. At that point, I suspect the farmer will decide to store corn and sell beans where necessary. What this means is I expect the cash market to struggle in the weeks/months ahead and this could be a drag on the futures market (for both soybeans and corn) during that period even if the crops do come in under my expectations.

Longer term, I view this year's situation in soybeans as very different than last year. Last year we were looking at a situation where we had a very poor US crop right on top of a very poor South American soybean crop. This year, while we might end up having another poor US crop, last year's South American soybean crop was very strong and thus the market is not quite as "tight" as we were seeing at this point last year. South American soybean production is likely to expand further this year, again assuming normal weather, meaning the US should see virtually no export demand in the second half of the 13/14 marketing year. Obviously there will be the usual snags with poor South American logistics, but those are temporary features that the market will sort out at the time. The bottom line is I don't see sharply higher soybean price potential in the long term unless we run into a weather problem with the South American crop. The upside potential in soybeans will likely have to come soon before the combines really start to roll.

I remain conservatively long the cattle market. I increased the long cattle positions in the past month, and while those positions did work out well for us I've decided to scale back on our exposure there for the moment. I'm slightly concerned that the nearby cash market won't be strong enough in the near term to support the premiums built in the futures right now. The cash market has been firm lately in part due to a decline in the cow kill. While I suspect we will see a return to low cow kill numbers later in the year and into 2014 that will once again create a spark to support cash (and by extension futures), there is a seasonal tendency for the cow kill to increase in fall months as calves are weaned. This combined with strong placed-against numbers for Sep/Oct could keep a lid on the cash market. Meanwhile the futures board has been very firm and has created an unusually wide basis. I think this will work to keep a lid on the futures in the short term, and as such I don't see a reason to remain aggressively long at the moment.

There does appear to be strong incentive for cow-calf producers to look towards heifer retention in 2014, and this could be an incredibly bullish factor for the 2014 contracts. However, unfortunately we just don't have any evidence of this yet and the market has already worked some pretty impressive premiums into some of these deferred contracts. With all of that in mind, I think it is a good time to be a bit less aggressive here and wait for an opportunity to add exposure to the 2014 contracts.

Regards,
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