Opus LLC
FUTURES

December 6, 2016

Agriculture Market Highlights:

Here in Memphis, the weather is finally starting to turn colder and it is starting to finally feel like the holiday season and year-end. Like many, I use this time to take a personal inventory of the year to review all the things that went right and wrong both personally and professionally. Looking at the program's YTD performance we can easily see that we've got more things wrong than correct this year. This has led to questions regarding whether the trading environment in commodity futures has changed to the point that our fundamental analysis is no longer useful in determining price action and instead the market has shifted more towards computer/algo trading as the new-normal. In a word, no...I do not believe anything has changed in terms of whether fundamental analysis can accurately forecast price direction. The problem this year wasn't that we didn't keep up with trends in futures trading, but quite simply we got the supply-side of fundamental analysis wrong. To illustrate these points, let's review this year.

Jan/Feb started off in a choppy manner, posting losses in January but recovering the losses in February. If you recall at the time we had just seen a massive devaluation in the Argentine Peso and we had been expecting a wave of farmer selling of soybeans to pressure prices into new lows. The selling pressure never really materialized, and this is the first example of getting our supply estimates incorrect this year. In hindsight, either Argentine stocks were not as big as most had believed or the farmer still has not been interested in selling (holding beans as a further inflation hedge). This prevented the flood of soybeans that had been expected and held off a collapse in soybean futures below the lows established in late 2015.

Starting late in March, the situation in South America began to change. Weather developments in Brazil and Argentina started to take a turn. In Brazil, we started to see dry conditions pop up through northern portions of the country. In Argentina, it was just the opposite, where excessive rainfall started to be seen through key production regions. While I was initially slow to react to the change in production prospects in March, we realized the losses were significant in April and we began to change our thinking. This lead to a major shift in our fundamental analysis on US ***demand*** prospects.

If you recall, I sent a mid-month commentary in April discussing the change in sentiment from bearish to bullish based on increased US demand prospects due to crop losses in South America. Up to this point, expectations for soybean demand were very low. For example, WASDE's April 16/17 soybean export projection was at 1,825 mil bu...a level ridiculously too low based on the demand we were now projecting coming to the US based on these crop losses. Soybean prices rallied from April through June, and by the end of June my monthly commentary showed demand expectations of roughly 4,065 mil bu for soybeans and I also showed a sharply smaller 15/16 carryout than prevailing consensus thoughts at the time. We were later proven correct on the 15/16 carryout and compare that demand projection to the current WASDE projection (as of 11/9/16) of 4,108 mil bu. In my opinion, this shows that we got the ***demand*** side of the equation correct and early on this year. Of course this is no reason to pat ourselves on the back. Our performance peaked in June, **so what happened?**

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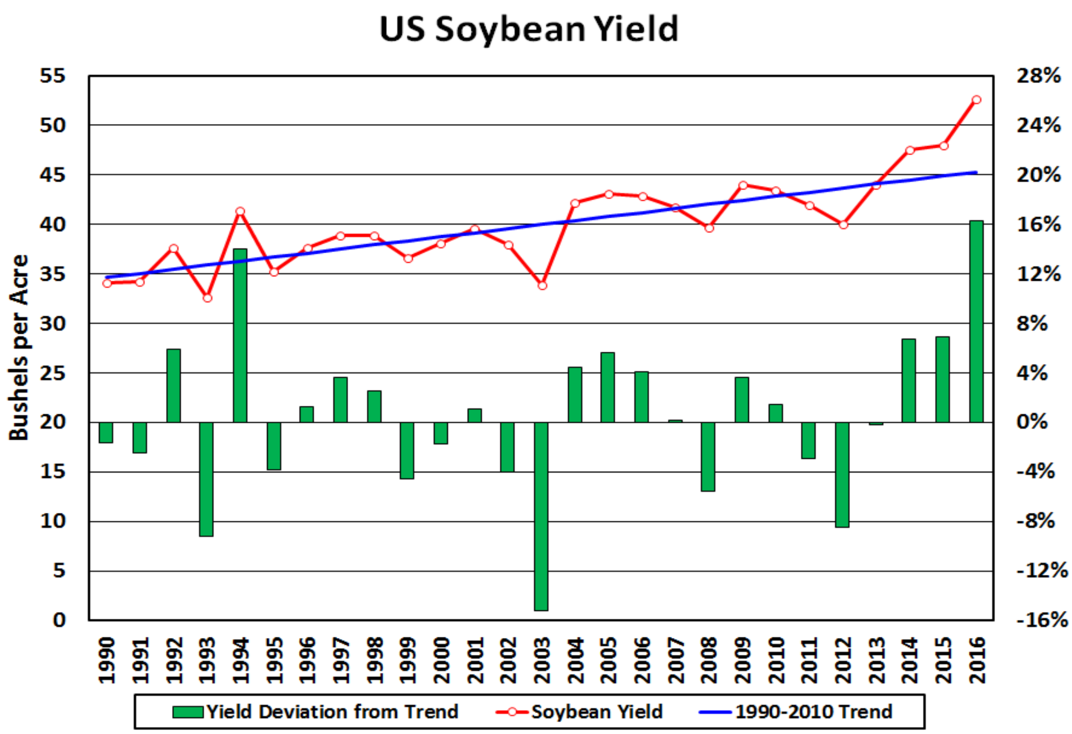
With the benefit of hindsight, we can now see that the rally in soybean prices through the end of June wasn't entirely due to the surge in demand we had rightly expected. Instead, it seemed that a huge speculative buying interest had developed on expectations for poor weather conditions into the summer. Through the end of June, those expectations had been well-fed by slightly drier than normal conditions across the US Corn Belt. However, starting the first week of July the forecast shifted dramatically wetter and it essentially never stopped raining until harvest.

Our long positions were punished in July and August as I had expected US demand prospects to support prices despite the improved weather conditions. What I did not imagine was just *how big* US production would eventually prove to be, and this <u>failure to accurately forecast US production was ultimately what led to our poor performance this year</u>.

Why did I miss so much on production this year? Typically forecasting US production is one of our strengths compared to other analysts and traders. We have very solid yield models and additionally we perform our own "boots-on-the-ground" crop scouting tour through the Corn Belt to determine production prospects. That usually gives us a head-start on knowing production rather than being behind the curve.



Simply put, our crop tour this year was a bust and our yield models were not equipped to project such a HUGE deviation from trend in soybean yields. As shown above, this past year's deviation from trend is the largest in modern history in both percentage terms and absolute terms. Corn yields also exceed our expecta-

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tions based on both our crop tour and yield models. Obviously both the crop tour and the models are under intense scrutiny and I'm still determining what to do in regards to crop projections for US summer 2017.

The point of the review on the prior two pages is two-fold. Firstly, I think it is very important to point out that price action this year has in fact been largely fundamentally based. We are not looking at a new paradigm as some have suggested in trading commodity futures. Yes, perhaps we will experience greater intraday volatility in the years ahead but the long term price movements are still largely guided by fundamental analysis.

The second point is to merely show what I got right and what I got wrong. I got the demand side of the analysis correct. If you were to plug in our demand projections from June (which are very similar to current WASDE projections) with anything near a trendline yield in soybeans, we'd be looking at a very different price picture right now. Of course this isn't meant to give myself a pat on the back, because obviously supply is what dominated trade this year and this is clearly an area in which I performed poorly. This can, and WILL, be corrected going forward.

Bottom line...fundamentals still matter, I've just got to get them right. My track record shows I have done that well in the past and I believe we have good days ahead.

With the year-in-review behind us, let's tackle what is going on presently and what this might mean for prices going forward.

Soybeans

At the time of writing soybeans are extending their recent rally. Spot soybeans are now roughly $1 higher than their fall lows. I must admit I am a bit perplexed in trying to determine the rationale behind the current rally. I think there are two major justifications: First, weather in Argentina has been less than ideal so far this season. Most of the key growing regions in Argentina has seen below normal precipitation over the past 30 days. While it is still very early in the Argentine season (key weather period is really late-January) this is a lingering issue that won't allow the market to "relax" until there are some signs of improvement. It is worth noting that weather thus far in Brazil has been excellent.

In addition, there have been concerns over Argentine weather and we've had a non-stop commodity rally in Chinese markets over the past few months. Virtually any commodity that is largely influenced by Chinese demand has rallied sharply. This includes soybeans, copper, iron ore, steel, and even garlic (yes, there are garlic futures traded in China). The question right now is whether this is true demand in China or a speculative buying flurry as is commonly seen in Chinese markets (for example the 2015 stock bubble). We can see that cash meal prices are inverted in China, which is certainly a signal of solid demand, but we've also started to see this relax slightly in recent days. As Chinese end users are able to extend coverage of Brazilian supplies in the months ahead, I think it is possible that Chinese markets can relax. If this is met with an improvement in Argentine weather, soybean futures could be vulnerable to a significant set back in the early stages of 2016. If, however, Argentine weather continues to be problematic, it could set the stage for further price gains in an effort to secure ample 2017 acreage in the US next summer. At the time of writing I have virtually no position in soybeans and I am awaiting better clarity on Argentine weather and production prospects before I establish a bias.

Corn

Corn prices have been range bound over the past few months and I would think that range-bound action is likely to continue ahead. However, based on the above mentioned Argentine weather concerns, corn does have some potential upside here as well. Keep in mind Argentine farmers are expected to plant much more corn this year and we have penciled in a significant YOY increase in production in our demand assumptions. Should Argentine corn production falter, it would shift demand back to the US for both later in 16/17 and much of 17/18. Prices also likely have to maintain a risk premium until we know more about Brazil's safrinha production, and that won't be known for several more months. With this in mind, corn downside is likely limited in the coming months. However, I also feel that upside should be fairly limited as well, unless South American weather really takes a turn for the worse. Corn supplies, and in general global feed grain supplies, are ample. WASDE is likely overstating US feed demand, though in fairness they're likely understating export demand. US farmers are sitting on cash supplies and will likely be more willing sellers in the new year on bounces. I look for choppy price action to develop a wide range in the weeks/months ahead. I have no strong conviction on a long term price direction until we have more clarity on South American production prospects.

It is worth noting that the current new crop soy/corn ratio is certainly encouraging a big increase in soybean area and this could partially reduce corn planting in 2017. This will be a theme to watch heading into the spring. I do not think we will see a 1:1 switch from corn to soy. However as we're also looking at smaller wheat area in the Plains, soybeans are not generally thought to be an option on these acres. These acres will normally switch to either corn or sorghum, but considering a recent bad experience with big sorghum production in the region I think corn will get the nod in most cases. With that in mind, I don't view corn area being a big upside issue for prices right now unless soybeans "steal" more than expected.

Wheat

I don't normally keep close tabs on wheat but I think wheat prices and spreads have reached levels that warrant some attention. Wheat/corn spreads are on recent lows and wheat prices in general have been continually sinking for what feels like a lifetime now. As noted above, this has discouraged wheat planting across the US. I believe consensus thoughts for winter wheat area this year are too high and this could be a bullish surprise for wheat prices at some point in the future. The problem right now is that wheat headlines remain dominated by strong supply levels. Australia's ABARES just released an updated wheat production estimate of 32.6 mmt, compared to prior expectations for production to total near 28 mmt. Right now the wheat market is still swimming in supply, making it difficult to hold out for potential price gains that might be months down the road. I view the risk/reward as skewed to the upside in wheat, but it will be a long term issue and we'll be forced to remain patient. Our first look at wheat planted area from the USDA will come in mid-January, and I'll likely want to have some wheat upside heading into that report.

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Livestock

I think cattle futures have some potential upside into the spring. We've seen very aggressive slaughter rates over the past several months and we've likely over-killed the nearby supply. The Dec 1 on-feed figure could be record small following such an aggressive marketing pace. Placements are starting to pick back up after a bit of a lull, but this won't replenish the cattle supply until the spring months. With that in mind I think feedlots will have greater leverage in the weeks/months ahead. Additionally, beef markets should be supported by strong export demand and limited imports (due to high prices of Australian beef). This should keep the packer relatively motivated to secure cattle supplies. This upside does have its limits, however, and as the increased placements of today start to hit in the spring, prices could resume their downtrend from that point forward.

Respectfully,

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