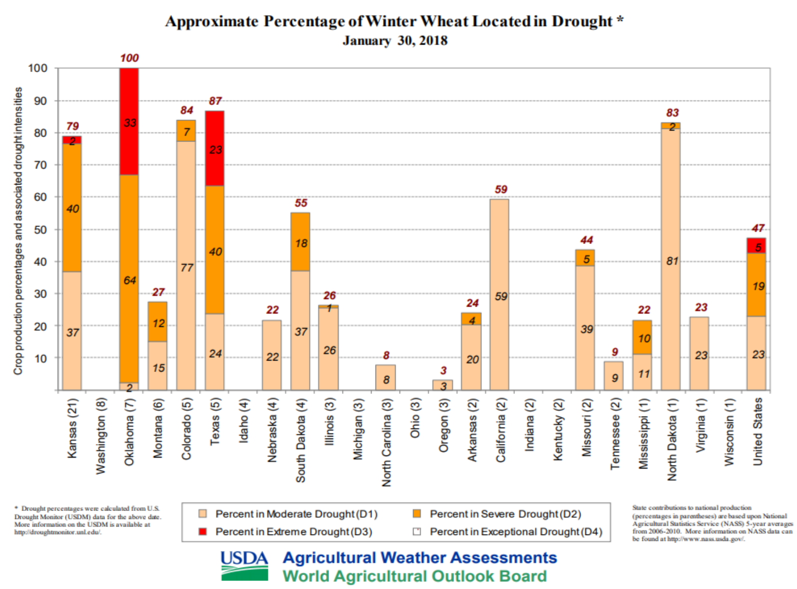
February 7, 2018

Advanced Ag Program Commentary

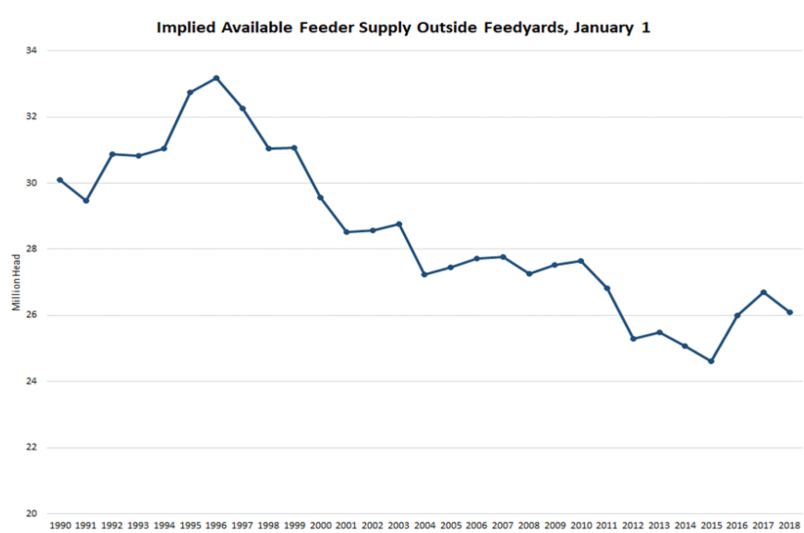
January proved to be a roller-coaster of a month, with several highs and lows experienced during a period of heighted market volatility. Considering all of the back-and-forth price action, I'm relatively relieved with our performance despite finishing slightly lower for the month. The good news is, despite the market action, very little has happened to change our long term bias towards markets.

We remain long wheat and this is primarily due to concern over HRW conditions in the Southern Plains. In just the past week, several state-level NASS offices updated winter wheat conditions and, simply put, they were not pretty. KS wheat conditions, the largest US wheat producing state, were estimated at only 14% good/excellent compared to 37% just one month ago and 44% at this time last year. Several other states in the Southern Plains (not to mention other areas of the country) also showed declining winter wheat conditions. This of course is the result of dry conditions that have plagued much of the middle of the country during the winter. The graphic below shows the estimate level of winter wheat production in drought condition by state as of last week. As you can see, there are major wheat producing areas that are experiencing significant drought.



Though this certainly represents a significant *potential* opportunity for upside later this year if dry conditions continue, we have to keep in mind winter is typically a dry period for the Southern Plains. What we are really concerned about is the outlook for spring precipitation, as it can easily turn the outlook/conditions around quickly. Right now, our preferred forecaster is calling for a high likelihood of continued dry conditions in the Southern Plains this spring. As long as that remains the forecast, we're going to lean towards the bullish side of wheat through spring.

There is also no change to my bearish bias on the cattle market, though admittedly that market has been tough to figure out so far in 2018. Cattle prices have surged strongly higher so far this year largely on three different factors. First, there was significant winter weather that created problems for a portion of the herd in January. I personally dismiss this as a reason for significant upside considering it came so late in winter and conditions were already so dry to begin with, but the market took the story and ran with it. Part of the reason it was so easy to run with this story is issue #2, which is strong "investment" demand for the sector. Major investment banks, particularly Goldman Sachs, have issued notes advising clients to be "overweight" in the livestock sector. What I find interesting is that I actually agree with their assessment that companies such as TSN and JBS should perform well in the environment.



9047 Poplar Avenue, Suite 101, Germantown, TN 38138

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However, I expect this to happen as packer margins will be very strong due to lower fed cattle prices as we work through oversupply this summer. That leads to point #3, which was the USDA's bi-annual Cattle Inventory report did *not* show the expected level of cattle supplies, and this brings into question whether we actually will see the oversupply I am expecting this summer. As shown below, the USDA's data actually shows a decline in available feeder supplies outside feedyards this year vs. last. That is simply something I cannot make jive with conversations with industry professionals around the country and I suspect USDA will be forced to revise their numbers higher in subsequent reports (which is <u>very</u> common to see for the Cattle Inventory data). Additionally, I believe the drought in the Southern Plains, assuming our forecasts are correct, will lead to a greater than expected level of placements earlier in the year than anticipated which will exacerbate the cattle supply situation this summer. Time will tell…..

Though I'm unchanged in sentiment towards wheat and cattle, I must admit I'm finding myself waffling in my thoughts on soybeans at the moment. In last month's commentary I pointed out prospects for higher Brazil production than the market was anticipating, and I still believe I was on the right course with that and we've seen several other analysts slowly and gradually raise their projections. However, weather in Argentina has been less than ideal over the past month and production losses have likely occurred. We're sitting at a pivotal spot in the Argentine growing season where rains are needed <u>now</u> to avoid <u>serious</u> losses. The good news is that an improvement in rainfall is expected in the forecast. The question now is: Does the forecast deliver and will it be enough to turn crop prospects around? In addition to concerns over Argentine supplies, I also have significant concerns over the willingness of the Argentine farmer to market his crop. Inflation in Argentina continues at an almost unbelievable pace (Buenos Aires CPI in December +26.1% YOY) so "hoarding" of the soybean crop as an inflation hedge makes some degree of sense if cash flow allows. Additionally, the Argentine government is allowing a monthly reduction of 0.5% in the soybean export tax. The lower the export tax, in theory the more the farmer can net for his soybeans. The combination of these two factors should encourage the Argentine farmer to hold on to his soybeans as best he can, perhaps by selling other crops first (such as corn) for cash flow purposes. This could support US export demand later this summer and/or fall, making short positions difficult to maintain despite the overall abundance of supply globally.

I am gradually turning more long-term bullish to corn, though I admit there is still a global supply overhang that we need to sort through in the coming months. Generally speaking, I think the industry has become too pessimistic towards US export prospects. Competing supplies into the summer/fall months are likely to be down considerably vs. year ago levels, supporting US export demand compared to very depressed expectations. Additionally, China continues to chew through their massive corn inventories and a day of reckoning will soon come when the government has to consider changes to their import restrictions or changes to their consumption policies. I expect China to turn to the world for potentially significant levels of corn (or other feedgrain) imports at some point in 2019. The bottom line is that world corn inventories are now fully contracting while demand continues to grow (most notably in China). Absent another massive crop in the US in 2018, I view downside in corn as very limited.

Best Regards,

David Zelinski

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