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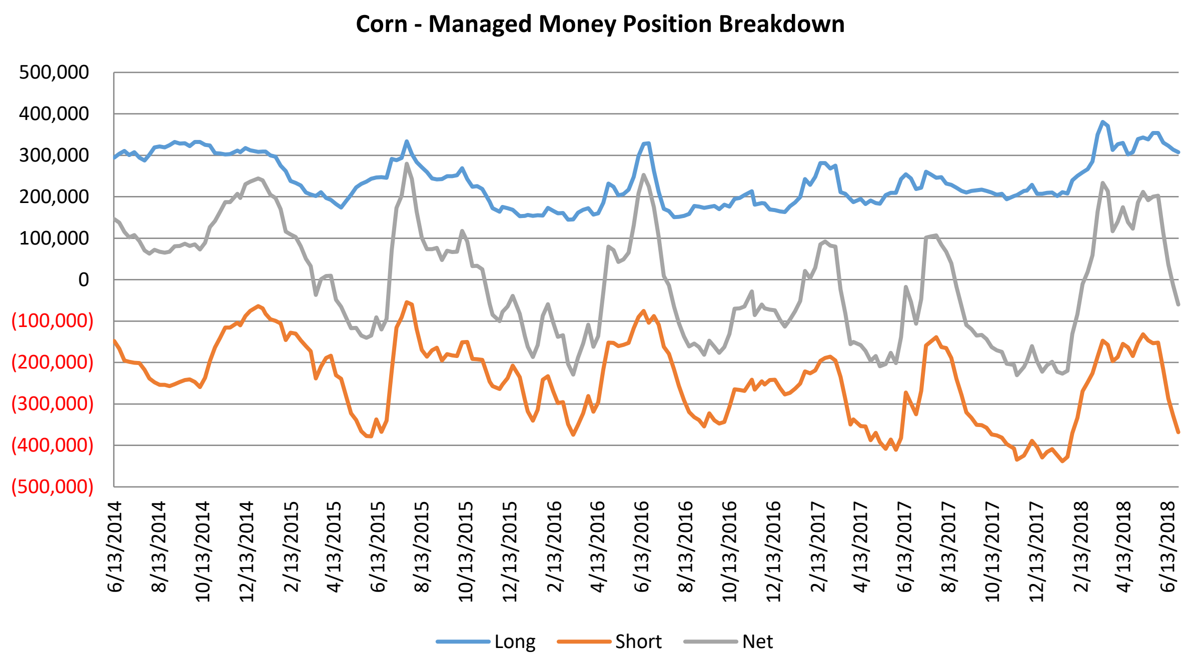
July 6, 2018
Advanced Ag Program Commentary

Another chaotic month has wrapped up. Obviously the only story anyone in the grain markets seems to want to talk about these days are the tariffs going into effect for Chinese imports of US products. Clearly this is a significant factor for soybeans, but over the course of the past month I intentionally focused most of my attention on corn. US corn exports to China are very minimal and thus corn prices should not dramatically be affected by the Chinese tariffs in the short term. Even if one were concerned about trade prospects with Mexico, on the initial list of potential items that could be tariffed, US corn was noticeably absent. The bottom line…even with trade wars swirling US corn demand remains very much intact. South American export lineups are growing marginally, but their supplies will be greatly reduced YOY due to significant crop shortfalls.

Speculative selling pressure has been *massive* over the past month, as shown in the chart below. Managed money traders have seen their gross short position increase by roughly 200,000 contracts during the month of June. As you can see below, this is getting close to the biggest gross short position we've seen in the past several years.



As I see things, there are two reasons for the massive amount of selling pressure we've seen over the past month in corn. First, of course, is the trade war fear. As mentioned above, this doesn't really directly affect corn right now (we will discuss 2019 prospects in a later commentary) so I believe this selling pressure to be somewhat misdirected. The other reason for the selling is a solid start to the US crop and favorable June weather. We saw excellent June precipitation spread across a widespread portion of the Corn Belt, allowing for mostly favorable conditions at the time of writing. Here again, however, I suspect the market may be getting

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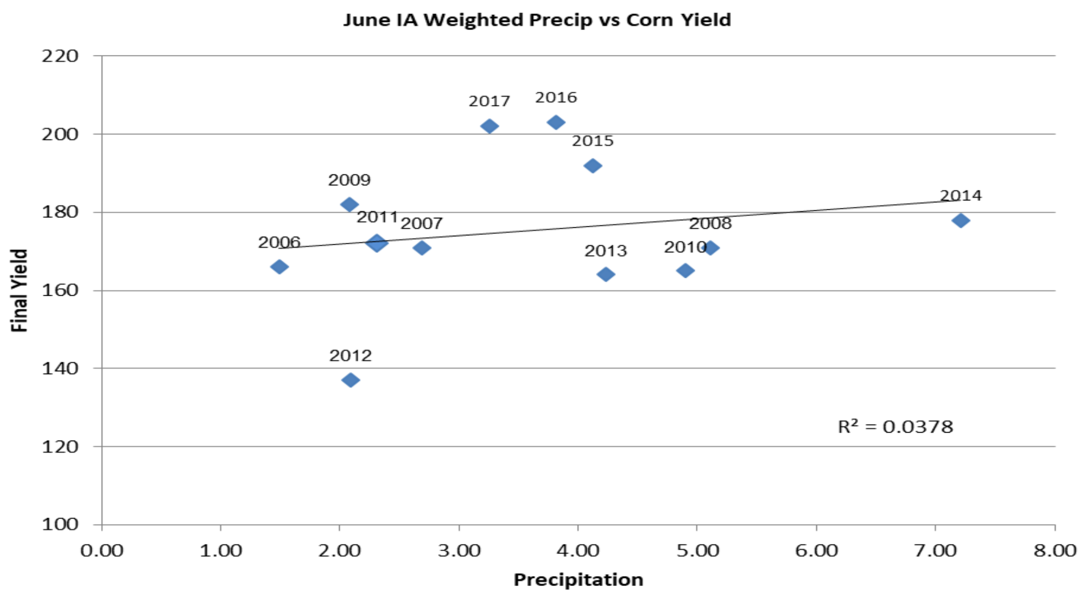
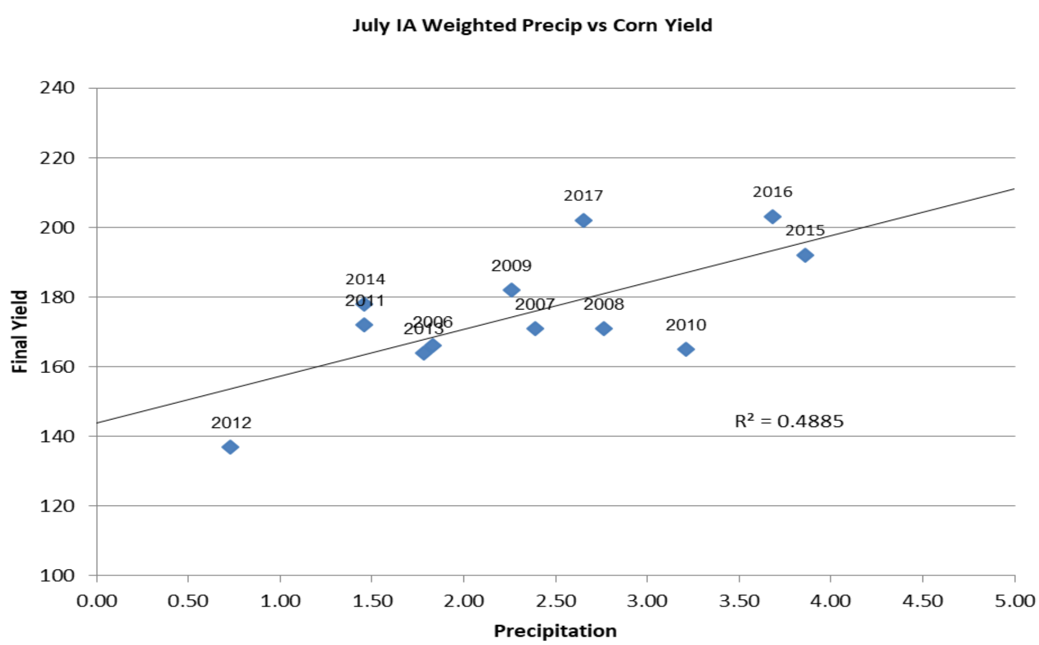
ahead of itself. Consider the graphics I show below. The first graphic shows corn-area weighted precipitation across the state of Iowa during the month of June vs. the final Iowa corn yield. As you can clearly see, there is virtually zero correlation with June precipitation and final yields. The second chart shows similar data, but using *July* precipitation vs. final yield. While it isn't a perfect correlation, you can see that July precipitation clearly lines up better with final yields than June. This is one reason WASDE's yield model has found June weather to be statistically irrelevant in their determination of trend yields.





I'm only showing the state of Iowa here, but other states show the same tendency. I'm not trying to say that June weather will have zero influence on final yield, but I am only trying to point out that the market has taken a lot of weather "risk premium" out of prices…perhaps prematurely. Current price levels are implying a massive record national average yield. I can't sit here today and completely rule out that possibility, but I'm also not willing to bank of it considering the forecast for much of the month of July calls for near to below normal precipitation and mostly above normal temperatures.

My bottom line opinion on corn, despite the rocky month of price action, is relatively unchanged from last month's commentary. I am expecting exceptionally strong export demand through at least Q1 of 2019. Despite the loss of Chinese demand, ethanol exports remain strong as well and the corn grind for ethanol continues to impress. The US crop is on solid footing but has a long way to go yet, while crops in Europe and the FSU are getting smaller. While further extreme weakness in soybean prices will affect corn sentiment, I eventually expect the two markets to divorce from each other and for corn prices to post at least a modest recovery.

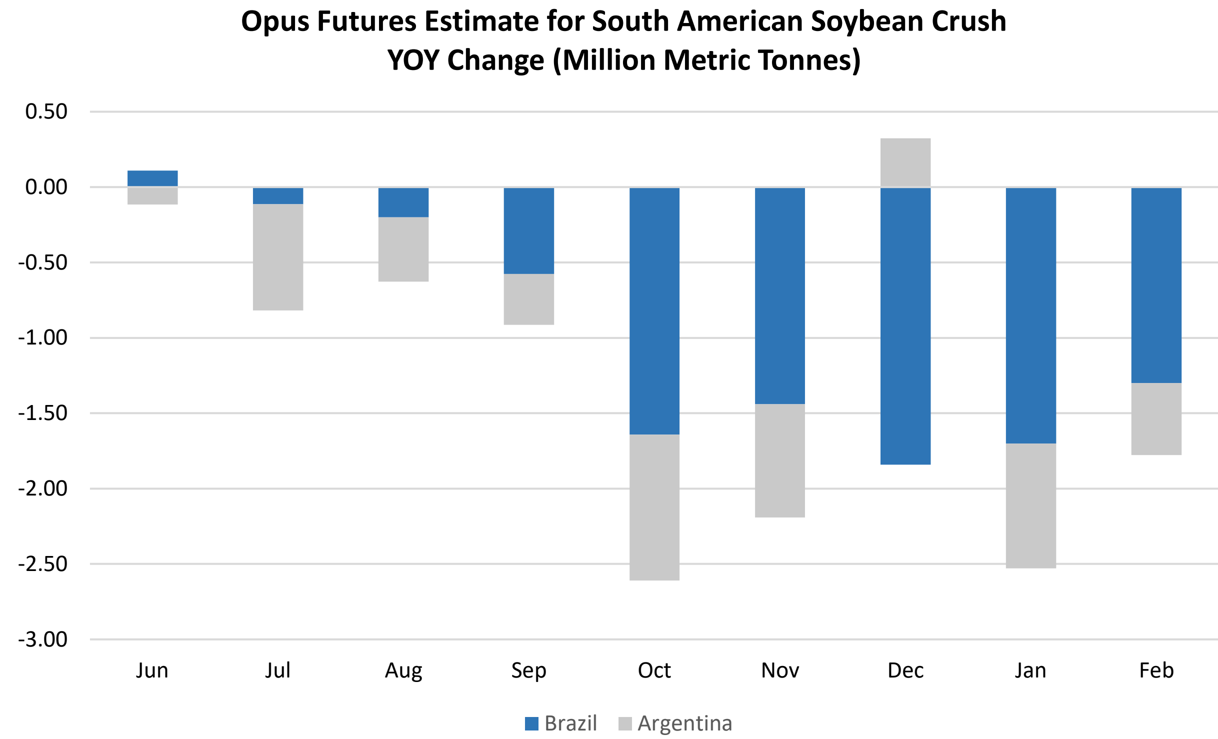
Turning my attention to the soy complex, obviously the tariffs China has put in place are price negative but we have to keep in mind that US soybeans are now the cheapest option to the rest of the world. Consider the rough estimates on prices below. These are not meant to be exact figures, but just rough estimates work for our purposes here.

US Value		Brazil Value	
SX	857.00	SX	857.00
Oct Prem	75.00	Oct Prem	225.00
Ocean Frt	1.24	Ocean Frt	0.94
Sub-total	933.24	Total	1082.94
Tariff	233.31		
Total	1166.55		

This is meant to show an approximate cost comparison to the Chinese crush between US and Brazilian supplies. Here you can see that US prices, after tariffs, are roughly 80 cents/bu higher than Brazilian supplies (Oct shipment). That should come as no surprise. However, it is also worth noting that to the rest of the world, which is (for now!) not tariffing US soybeans, we are decidedly less expensive. At least initially, that demand from the rest of the world will somewhat cushion the blow from the loss of Chinese business.

The second order effect on the above math is that as Chinese crushers start to cover their forward needs (we estimate the Chinese have <u>very little</u> coverage beyond Sept), we should see the Brazilian premium levels skyrocket to historically unheard of levels. Remember, due to Argentine crop losses and farmer hoarding of what they have (due to ongoing runaway inflation), Brazilian supplies will be essentially all that is available to the Chinese crusher.

This will have two impacts. First, as Brazilian premiums rally we should see the Brazil-US price spread to China narrow significantly and perhaps to the point that US soybeans could work into China even after the tariff. I think that would be an interesting test of the Chinese resolve here. Will they allow US soybean in after the tariff or are we looking at what is essentially an embargo? Secondly, the rally in export premiums in Brazil will choke off soybean supplies to Brazilian crushers. Crush margins in Brazil will go negative and crush operations will grind down to a bare minimum. There has been talk that Brazil could import soybeans from the US to fuel their crush operations, but I have <u>major</u> doubts that logistics allow for significant quantities. With Argentine soybean supplies diminished sharply by their drought this season, we could be looking at significant YOY reductions in South American crush, which will turn the world to the US to cover soybean meal import requirements.



The chart above breaks down how I think South American crush rates will progress into early next year, compared to year ago levels. If you combine the total YOY reductions, we're looking at potentially 12 mmt of smaller soybean crush during this timeframe. That will mean world meal importers will increasingly turn to the US for their import needs, but the US's crush capacity is only so big. In the end, I think this could result is a massive "squeeze" of hand-to-mouth global end users, which could lead to dramatic upside in soybean meal prices and spreads. On the margin, that could also be modestly supportive to soybean prices, though I think we should see crush margins widen to record levels.

To wrap up my opinions on the grain markets at the moment, I think corn has some modest upside in the near term on an oversold conditions in addition to weather developments for the remainder of the month. I also think exceptional demand this fall should provide a floor under the market near recent lows. I am friendly to meal flat price and calendar spreads. Soybeans will continue to struggle due to the lack of Chinese demand, but it will be very difficult to trade as the market needs to move US beans to supply the rest of the world.

Turning quickly to the cattle market, I do believe we have some modest upside potential in fall contracts in the weeks/months ahead. Earlier this year we noted that we should have huge supplies into the summer and we were bearish and took advantage of that price break. We are now coming to the other side of those big supplies, and our projections for August through the end of the year actually show a modest YOY decline in available cattle. The seasonal lows in cash cattle prices should be in, and I believe there to be upside in October cattle to the 118-120 level.

Apologies for the longer than usual commentary, but I wanted to spend a bit more time than usual in explaining the thought process this month.

Thank you,

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