AGRICULTURAL PRICES AND INFLATION ("DESPERATE HOUSEWIVES", EPISODE 8)

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In William Faulkner's "The Sound and the Fury", an exasperated cotton speculator remarks (Faulkner's punctuation): "I dont see how a city no bigger than New York can hold enough people to take the money away from us country suckers. Work like hell all day every day, send them your money and get a little piece of paper back, Your account closed at 20.62. Teasing you along, letting you pile up a little profit, then bang! Your account closed at 20.62. And if that wasn't enough, paying ten dollars a month to somebody to tell you how to lose it fast, that either dont know anything about it or is in cahoots with the telegraph company. Well, I'm done with them. They've sucked me in for the last time. ...I just want to hit them one time and get my money back. I dont want a killing; only these small town gamblers are out for that, I just want my money back...."

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CONCLUSION

The supply/demand picture of agricultural playgrounds such as wheat, corn, soybeans, cotton, sugar, coffee, and cattle of course vary. Yet depending on the arenas and situation, fundamentals and price trends of a given agricultural commodity may substantially or increasingly intertwine with one or more other agricultural ones. The landscape of agriculture (though energy costs matter to it) is not typically viewed as the realm of energy. The fertile fields of so-called financial arenas like equities, interest rates, and currencies do not officially incorporate farming or energy. Nevertheless, agriculture is not an economic island entirely or even substantially separate from energy and financial provinces. Recent history underlines that the agriculture complex "in general" does not inevitably or always possess such independence. Not only traders in energy (and base and precious metals), but also foreign exchange, equity, and interest rate players, should monitor agricultural price levels and trends.

Governments and international organizations build numerous yardsticks to measure inflation. Not only do these indicators within a nation vary in the importance they assign to agricultural phenomena. Benchmarks between countries can differ, perhaps substantially. Picture a consumer price index of an advanced (industrialized; OECD) nation in contrast with one of a relatively poor developing country. Despite such variations, **elevated and rising agricultural prices alongside similar patterns in the petroleum complex (and many metals) make it increasingly difficult for central bankers, finance ministers, and their political friends to claim that inflation levels will remain low. The withering of the United States dollar (broad, real trade-weighted basis; "TWD") has assisted rallies in commodity prices.**

The longer food- and other agricultural and energy prices- stay lofty, the more difficult it is to claim that so-called core inflation will remain (is) unaffected by them. Consequently, interest rate gatekeepers around the globe- even America's stubborn Federal Reserve Board- face more and more pressure to boost policy rates.

When will there be a noteworthy peak (even if it is not a final summit) for agricultural prices in their current bull stampede? Trends in other marketplaces will influence the level and timing of agricultural price pinnacles. Anyway, use the S+P GSCI Agriculture Index as a guidepost for "agriculture in general". The arrival of many key crop harvests (supplies) and past timing of some key trend changes (in agriculture and elsewhere) suggest one should look for a price decline to commence sometime around mid-April through July 2011.

AGRICULTURE: A CURRENT GLANCE

In the film "Random Harvest" (director, Mervyn LeRoy; 1942), Smithy says:
"You and I are in the same boat, Miss Hanson; we're both ghost-ridden prisoners of our past."

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A survey of recent price and time history (2008-present) of the S+P Goldman Sachs Agriculture Index in the context of other key marketplaces displays the merit of monitoring agricultural price and time trends alongside them. Note the roughly similar timing of several key trend changes.

As of 12/31/10, the S+P GS Agriculture Index was about 26 percent US wheat, 25pc corn, 15pc soybeans, 16pc sugar, around 10pc cotton, with coffee about six pc and cocoa just under two pc. The broad S+P GSCI index includes these "agriculture" commodities, but they make up only 17.4pc of the index (12/31/10; livestock is a separate 4.3pc). The broad GSCI is heavily weighted toward petroleum. As of 12/31/10, the broad GSCI was around 63 percent petroleum (almost fifty pc crude oil; natural gas was just over three pc of this index).

L = Low, H = High. The broad, real trade-weighed dollar is a monthly average.

GSAg Index	Broad GSCI	S+P 500	Broad Real TWDollar
Low 268 (3/2/09) (final low; initial bottom 12/5/08 at 246)	Low 306 (2/19/09)	L 667 (3/6/09)	High 96.7 (March 2009)
L 281 (6/7/10)	L 459 (5/25/10) + 490 (8/29/10)	L 1040 (8/27/10) + 1011 (7/1/10)	Fell more from minor H: 89.7 June 2010 +87.6 Aug 2010 [Euro FX v $ lows: 1.1877 on 6/7/10 and 1.2590 on 8/25/10]
L 424 (11/23/10) + 380 (10/4/10)	Low 556 (11/23/10)	L 1174 (11/30/10)	TWD heads toward all-time low of 84.0 (1973-present); breaks it January 2011 at 83.7.

The **US Treasury 10 year note** reached its yield low on 12/8/08 at 2.04pc, a few months earlier than commodities, stocks, and the dollar. More recently, remember the Federal Reserve engaged in new rounds of quantitative easing in mid summer and autumn 2010 (its decisions around 8/10 and 11/3/10). The US 10 year note made a very important yield low in between the Fed announcements, on 10/8/10 at 2.33pc.

The TWD probably kept slumping in February 2011 (based on a review of the daily nominal TWD values).

What about the period just before what this table outlines, as the worldwide economic crisis began to emerge?

The high in the GS Agriculture Index was 2/27/08 around 513 (just before gold's major top at 1034 on 3/17/08), with the final peak 496 on 6/26/08. The major high in the broad GSCI was achieved not long after that late June high, on 7/3/08 around 894. The real TWD achieved an important low at 84.0 (the level of previous major bottoms) shortly before this, in April 2008. Though the major high in the S+P 500 was in October 11, 2007 at 1576, its final peak on 5/19/08 at 1440 was not distant from the 6/26/08 top in the GS Ag Index and the 7/3/08 height in the broad GSCI. What about the US Treasury note arena? A final yield high in the US government 10 year note shortly preceded this June 2008 GS Agriculture plateau. Recall 6/13/08's 4.27 percent (one year after 6/13/07's 5.32pc).

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Going further back down the road of time, recall the GS Agriculture index low of 4/29/02 near 150. The major high in the TWD occurred not long before that, in February 2002 at 112.6.

Other key price and time levels to remember for the GS Agriculture Index include the springtime take-off low point in the uptrend, 5/21/07 near 244. Recall 1996's calendar top: around 334 on 4/25/96.

Don't ignore the ancient highs of 11/20/74 around 496.3 and 11/5/80 around 404.5.

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Watch the United Nations's Food and Agriculture Organization's "Monthly Food Price Index" alongside the GS Agriculture Index. This FAO index reached a new record high in February 2011 at 236 (2002-04=100; data back to 1990). Recall the calendar timing of past highs in this index in June 2008 at 224.1 and May 1996 at 137.2 as well as the major low at 85.3 in May 2002. In regard to the May 2002 low, don't forget the time of the 2002 high in the TWD.

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Cole Porter penned the song "Always True to You in My Fashion"; the lady warbles "From Ohio, Mister Thorne…Calls me up from night 'til morn, Mister Thorne once corner'd corn and that ain't hay."

In Wall Street trading dens, the timely arrival of a suitable lunch is an important and expected event. We all know people have to have food. When agricultural inventories erode to very low quantities, or threaten to do so, people enthusiastically (perhaps even desperately) act to insure supply. People don't have to eat stocks, bonds, and currencies. Agriculture is not divorced from politics (and social stability), whether in the United States, China, the Middle East, or elsewhere.

Physical (cash) commodity marketplaces- particularly when viewed from the inventory perspective- are small in value in comparison to the worldwide equity and interest rate universe. To try to grasp sufficient supply (or whatever inventory is out there), there's a lot of money around. Let's take a narrow snapshot. The US Department of Agriculture's "World Agricultural Supply and Demand Estimates" ("WASDE"; 2/9/11) places US 2010/11 corn production at 12,447 million bushels, with ending stocks at 675 million bushels. Suppose corn sold at eight dollars a bushel, above current prices. The value of US corn production equals just under $100 billion, with closing inventory at about $5.4 billion. In December 2010 (official and private holders combined), Mainland China held $1,160 billion (yes, almost $1.2 trillion) in United States Treasury securities, Japan held $882 billion, and "Oil Exporters" owned almost $212 billion. (US Treasury, 2/28/11).

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Assuming normal weather and agricultural yield trends, increased plantings and harvests during 2011 in the US (see "Prospects for the U.S. Farm Economy in 2011"; noted below at p6) and elsewhere probably eventually will halt the current explosive price rally. However, what about the so-called long run? People hope for yield increases to satisfy consumption cravings and meet expected population growth trends. To what extent will more land become available if agricultural prices are stratospheric? To reduce food demand, how high must agricultural prices soar?

What are some key levels and ranges to monitor in the Goldman Sachs Agriculture Index? One can conjecture as to what levels are "reasonable" and when (if at all) they could be achieved and how long they could be sustained. Moreover, it must be emphasized that this index may never reach some of the very elevated new high ground indicated in this list.

***424 (the 11/23/10 take-off point)
***496 (6/26/08 final high)/513 (the 2/27/08 peak)
***537 (twice the 3/2/09 bottom of 268.4)
***560/565 (562 is twice the 6/7/10 bottom; 565 is about 1.33 times the 424 low on 11/23/10; 564 is a ten pc move over the 2/27/08 top)
***600 (about four times the 4/29/02 major low)
***636 (1.5*the 11/23/10 valley)/671 (2.5* the 3/2/09 low; 668 is twice the 4/25/96 top)
***No marketplace grows to the sky. However, imagine 750 (about five times the 4/29/02 trough; about a 50pc move over the 11/20/74 peak).
***805 (three times the 3/2/09 low)
***1000 (about twice the 11/20/74 peak)/1025 (double the 2/27/08 top).

AMERICAN POLICIES

In "Sweet Wine", Cream sings:
"Who wants the worry, the hurry of city life.
Money, nothing funny, wasting the best of our life.
Sweet wine, hay making, sunshine day breaking.
We can wait till tomorrow."

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All else equal, money printing (quantitative easing) raises prices in commodities and goods and services denominated in that currency. From the United States perspective, all else equal, a weakening US dollar also boosts such prices. Low interest rates often make it attractive to own "assets" other than interest rate obligations.

Commodity price levels and trends influence interest rate levels and trends, as well as other marketplaces. People can debate as to how much. To some extent, agricultural and energy (and other commodity) prices influence overall consumer spending patterns and net worth.

The generally increasing popularity of commodities as an "asset class" (and "diversification tool") for "investors" has been a bullish price factor for the commodity pasture. It reduces free supply (readily available inventory), though observers can quarrel how much. The CFTC's CIT Report details "Index Trader" holdings for a dozen agricultural commodities. Index Traders are roughly equivalent to the earnest buy and hold for the long run alternative investment crew. As of 3/1/11, they net Index Trader long position (futures and options combined, all commodities combined) equals around 21 percent of total open interest. Since end 2006, the average net Index Long percentage of total open interest has been around 25pc. These percentages are not trivial.

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The Federal Reserve continues to be rather unconcerned about excessive inflation. Thus they appear willing to permit interest rates to remain low and the broad real trade-weighted dollar to remain feeble (and weaken further). So in practice, these guardians are not overly

troubled by recent rallies in agriculture and energy and will not try (at least for now) to make serious efforts to stop them. See "American Debt Gardens- Higher Yields ("Desperate Housewives", Episode 7)" (2/8/11) for further analysis of Fed policy, inflation measures such as the Consumer Price Index, and related issues.

Take a look at very recent Fed policy comments. The President of the NY Fed ("Prospects for the Economy and Monetary Policy", 2/28/11) barks that although "the economic outlook has improved considerably….we are still very far away from achieving our dual mandate of maximum sustainable employment and price stability." He adds: "both headline and core inflation remain below levels consistent with our dual mandate objectives." And: "there are important mitigating factors that suggest it would be unwise for the Federal Reserve to over-react to recent commodity price pressures."
http://www.newyorkfed.org/newsevents/speeches/2011/dud110228.html

The Federal Reserve Chairman's opinion regarding the economic outlook and the Fed's closeness to achieving its policy aims is similar to that of the NY Fed's boss. He worries about unemployment, describes a weak housing sector, and believes there is a high level of resource slack (output gap). Bernanke is not too worried about too much inflation. This sentinel calmly asserts: "Thus, the most likely outcome is that the recent rise in commodity prices will lead to, at most, a temporary and relatively modest increase in U.S. consumer price inflation..." However, this captain confesses: "sustained rises in the prices of oil or other commodities would represent a threat both to economic growth and to overall price stability, particularly if they were to cause inflation expectations to become less well anchored." ("Semiannual Monetary Policy Report to the Congress", Senate Committee on Banking, Housing, and Urban Affairs, 3/1/11).
http://www.federalreserve.gov/newsevents/testimony/bernanke20110301a.pdf

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Although many factors intertwine to affect United States dollar levels and trends, financial responses to actual and potential inflation matter. **Like the Fed and other regulators, most US politicians presently do not talk or act worried about the continuing decline of the dollar.** To the extent the Fed refuses to increase yields as inflation emerges, that tends to cut the greenback's value. At some point during further dollar deterioration, US guardians will bellow about the need for a strong dollar. Would a five to ten percent decline in the broad real trade-weighted dollar relative to its prior historic low around 84.0 help to induce a Fed interest rate increase?

To the extent American politicians squawk loudly rather than act prudently on the deficit, this further wounds the dollar. Washington recently has been fluttering regarding proposed deficit cuts of about $60 billion for 2011. Yet as the famed television commercial of Wendy's hamburger chain asked 25 years ago, "Where's the beef?" Even if Congress slashes $60 billion, this is only about four percent of an overall 2011 deficit of nearly $1.5 trillion.

Watch US inflation protected securities (TIPS). The 10 year breakeven inflation rate (comparing UST yields with TIPS reached 2.51pc last week, the highest since July 2008. (Financial Times, 3/4/11, p21).

<u>FOOD AND INFLATION RISKS</u>

"It could be a spoonful of coffee
It could be a spoonful of tea
But one little spoon of your precious love
Is good enough for me." "Spoonful", by the famed blues artist, Willie Dixon.

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For crops such as corn (and other coarse grains), wheat, soybeans and other oilseeds, and sugar (and don't forget coffee), it will take more than a few spoonfuls of supply to solve current (or prospective) low inventory situations.

Despite the current relative lack of fears by the Fed and many other financial policymakers regarding elevated inflation in general, many agricultural experts are not all sunny on both near term and long run fronts regarding agricultural supplies. Thus debt, equity, and currency watchers should not be complacent about the inflationary consequences of agricultural supply/demand and price action.

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In "Prospects for the U.S. Farm Economy in 2011" (2/24/11), the USDA's Chief Economist declares that higher crop prices will cause more about 9.8 million more acres (about four percent) planted in 2011 for the eight major field crops (these include wheat, corn, soybeans, cotton). This will be the highest since 1998, but about five million acres less than 1996's 260mm acres. However, although he offers significant detail and some caveats, the bottom line is that wheat, corn, and soybean marketplaces probably will remain tight for 2011/2012.

The USDA's Chief Economist seems less optimistic on the inflation front, at least as it applies to food, than the Fed's financial gurus. "After two years of relatively low inflation, higher prices for crops and livestock will again pressure food prices….Higher commodity and energy prices are expected to lead to a stronger increase in retail food prices in 2011. During the previous spike in commodity and energy prices in 2007 and 2008, the CPI for food rose by an average of 4.7 percent over the two years. The Economic Research Service has increased its forecast for the all food CPI to 3-4 percent for 2011. This could mean year-over-year inflation rates in excess of this average in the latter part of 2011."
http://www.usda.gov/documents/Glauber_Joe_Speech.pdf

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The US Secretary of Agriculture recently ruled out any change in America's ethanol policy. "'There's no reason for us to take the foot off the gas.'" (Financial Times, 2/25/11).

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The next USDA WASDE report is 3/10/11, then 4/8/11. Those curious about very long term agricultural supply demand from the US perspective should scan "USDA Agricultural Projections to 2020" (February 2011).
http://www.ers.usda.gov/Publications/OCE111/OCE111.pdf

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What about the worldwide food situation for the very long run? The UK's Government Office for Science "Foresight Project", "The Future of Food and Farming" (1/24/11) describes at great length the challenges facing future agricultural production. **"The global food system will experience an unprecedented confluence of pressures over the next 40 years. On the demand side, global population will increase from nearly seven billion today to eight billion by 2030, and probably to over nine billion by 2050; many people are likely to be wealthier, creating demand for a more varied, high-quality diet requiring additional resources to produce. On the production side, competition for land, water and energy will intensify**…" ("Executive Summary", p9; see pp15-16).

"Overall, relatively little new land has been brought into agriculture in recent decades. Although global crop yields grew by 115% between 1967 and 2007, the area of land in agriculture increased by only 8%...While substantial additional land could in principle be suitable for food production, in practice land will come under growing pressure for other uses." (p15).

Moreover, "There is substantial evidence for increasing global demand for food (which probably contributed to the recent food price spike."; "Food security in 2030 and out to 2050 will require new knowledge and technology…" (p37).
http://www.bis.gov.uk/assets/bispartners/foresight/docs/food-and-farming/11-547-future-of-food-and-farming-summary.pdf

The Foresight Project's extensive documents have heaps of other interesting details. See, for example, those in "Synthesis Report C1: Trends in food demand and production". World per capita food consumption in 2003/05 was about 2771 kcal/person/day (Table C1.1, p4). Predictions in the Foresight Project (Table C1.4, p33) show world per capita consumption at 2950 kcal/person/day in 2015 (up 6.5pc from ten years before) and 3040 kcal/person/day in 2030 (a 9.7 boost over the 2003/05 level).
http://www.bis.gov.uk/assets/bispartners/foresight/docs/food-and-farming/synthesis/11-621-c1-trends-food-demand-and-production.pdf

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The NYTimes discusses substantial rises in US Midwest farmland prices: "Raising Concerns About a Bubble" (3/4/11, pB1). But despite its quantitative easing quest, the Federal Reserve Board cannot print land.

POLICY MEETINGS….POLICY CHANGES?

The Federal Reserve Board meets 3/15/11 and 4/26-27/11.

Will interest rate boosts by the European Central Bank, China, or elsewhere help to spark commodity price declines?

International Monetary Fund /World Bank spring meeting and related events are 4/12-17/11. Are official gold sales, with proceeds designed to aid the food and fuel needs of poor nations, inconceivable?

Given agriculture's current intertwining with petroleum and various financial marketplaces, changes in official petroleum policies may influence agricultural price trends. For example, at what petroleum price (and inventory) level would the US and others release strategic petroleum stocks. Could current Middle East unrest and potential tightness in supplies (especially for sweet crude) prompt official sales? The NYTimes headlines "Calls Mount to tap U.S. Oil Reserves" (3/4/11, pB1). The NYTimes also announces (3/7/11, pB6) that "Obama Considers Tapping Oil Reserve (citing the White House chief of staff's 3/6 interview on NBC's "Meet the Press"). OPEC meets 6/8/11.

Might US regulators impose tighter position limits, higher margin requirements, and more severe restrictions on permitted delivery quantities in agriculture (and petroleum) if prices stay high alongside very low inventories?

What are the chances of tax rule changes to reduce the attractiveness of commodity holdings (at least in futures and other forward marketplaces) by pension funds and similar money managers?