



Volume XV No. 5
October 2007

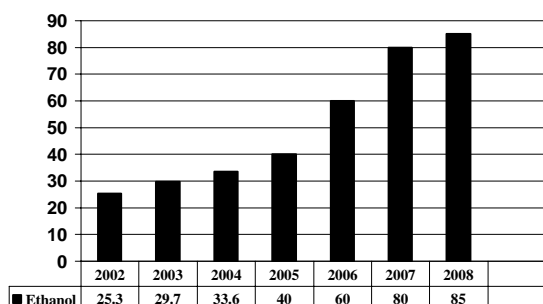
Corn Use for Ethanol Slows in the US

The use of corn in the US to produce ethanol doubled from 1.6 billion bushels or 40 MMT in crop year 2005-2006 to 3.2 billion bushels or 80 MMT in crop year 2007-2008. This corn grab on the part of subsidized ethanol producers increased the world price of not only corn but also soybeans, wheat, rice and all other grains consumed by animals and people.

The 80 MMT of corn used to produce ethanol in the US this crop year is 24% of the US harvest of corn and represents an amount equal to 70% of all coarse grains (corn plus sorghum) traded worldwide. This is probably close to the high water mark for corn based ethanol. The negative affects of increased corn use for ethanol will be reduced in the short term by the inability of the gasoline industry in the US to absorb all of the ethanol produced. This "blend wall" is caused by the inability of the ethanol infrastructure to absorb all of the new production. In addition, the bumper crop of corn in the US mitigates somewhat the effects of the use of corn for ethanol.

In the long term, the affects of ethanol on the price of corn will be reduced by the weakening of political support for subsidized corn based ethanol. Nevertheless, the cooling of the ethanol boom will come too late to stop a substantial increase in the price of feed and food that has been witnessed in the last 12 months and will continue for the next 12 months.

US Corn Use for Ethanol in MMT

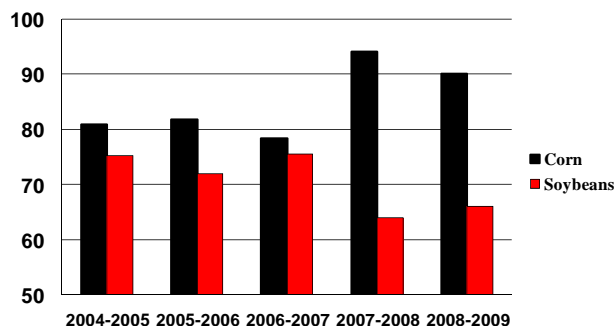


Last year, as a result of the soaring use of corn for ethanol, US inventories fell by half from 2 to 1 billion bushels (50 to 25 million tons). Falling inventories pushed the average US farm price of corn up 50% from \$2 to \$3 per bushel (\$80 to \$120 per ton). Higher prices, in turn, led to significantly increased planting of corn and a much higher crop that is now being harvested. For the moment, there is plenty of corn for all uses. Inventories are likely to return to 2 billion bushels.

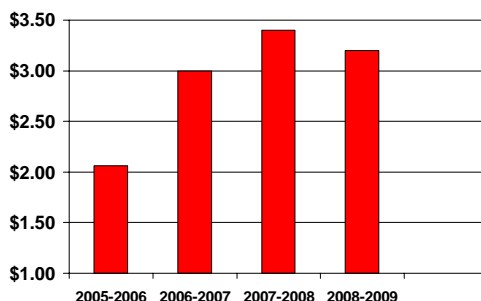
The increase in corn supplies this year was obtained by a huge one-time increase in the amount of land dedicated to corn. This shift in land to corn came out of land that previously was used for other crops, most notably soybeans. As a result, soybean prices rose to higher levels as has the price of wheat and other grains (higher wheat prices were also influenced by a second year of drought in Australia). With high prices all around, corn will no longer be able to make any further land grabs and in fact is likely to lose some land next year.

As a result, the price of corn is unlikely to fall despite higher production and may continue to rise somewhat over the next 12 months. As can be seen in the following graphs, the price of grains and oilseeds reach their peak this year.

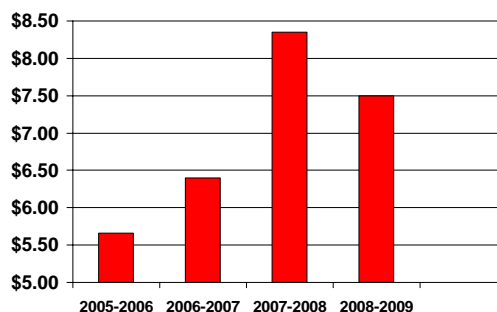
Corn and Soybean Plantings – Millions of Acres



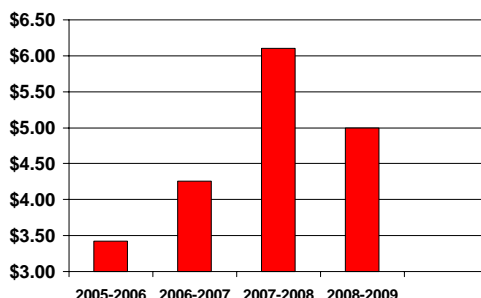
Farm Corn Price - \$/Bushel



Farm Soybean Price - \$/Bushel



Farm Wheat Price - \$/Bushel



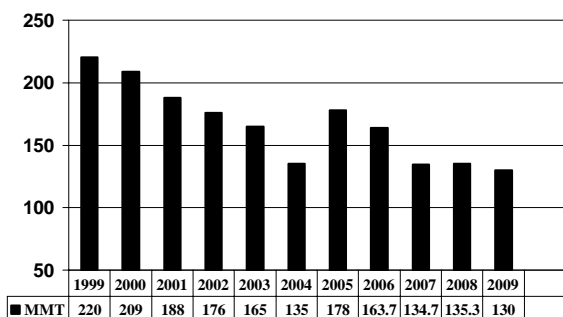
The world is witnessing the consequences of a demand shock to the world grain supply system. It is a shock which is having its most profound consequences at this moment. Next year the rapid increase in ethanol production should have ended and the world grain supply situation will be able to begin to return to normal.

World Coarse Grains Situation

World coarse grain prices are heavily influenced by events in the US. No country or region provides a counterweight to the US in the production of corn. The world currently depends on the US for over half of all exports of corn. The US this year will export 60 MMT of corn. The second largest exporter of corn, Argentina, will export only 10 MMT. In the event of a drought, the 80 MMT burden of ethanol production in the US will result in a combination of sharply curtailed exports, a slowdown in the ethanol industry and livestock liquidation as well as sharply higher prices.

The world's inventory of coarse grains fell for five years in a row reaching a low level in 2004 before the record US corn harvest in 2004. After a respite of two years, world inventory fell below the levels of 2004 this year. Despite a huge increase in US corn production, world inventory will only increase slightly in 2008 and fall again in 2009. With this backdrop of tight supplies, world corn prices are rising and becoming more volatile.

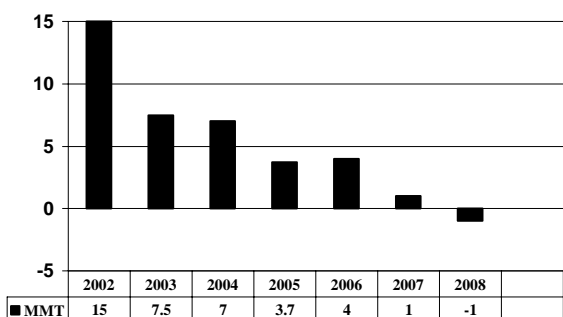
World Coarse Grain Ending Inventory - MMT



Corn and China

As is the case for many commodities, the situation in China must be taken into account. China is moving from being a net exporter to a net importer of corn and is likely to become a net importer starting in 2008-2009. The swing from net exporter to net importer of corn will lend support to the world increase in corn prices.

Net Corn Exports - China



Increased prices will stimulate increased corn production around the world thereby eventually limiting the rise in corn prices. The potential is still great for increasing yields in many countries, most particularly in China. In addition, countries such as the Ukraine and Russia are nowhere close to using the amount of land that could be dedicated to corn production.

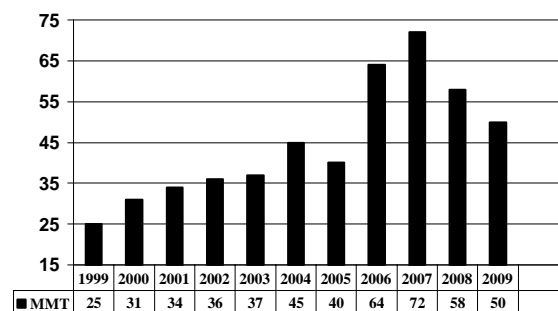
Soybeans

Because of the land grab by corn, the world soybean situation has deteriorated. The sudden loss in land area planted to soybeans combined with a world shortage of wheat and corn, has limited the amount of land planted to soybeans. As a result, soybean inventories are on the way down and soybean prices on the way up.

The upward limit to soybean meal prices is somewhat limited by the fact that the protein from corn is not destroyed in the production of ethanol. Distiller's dried grain (DDG) by-product of the production of ethanol in the US is a protein substitute for soybean meal. Therefore, the rapidly rising production of DDGs in the US will tend to limit the increase in the price of soybean meal. Even the production of bio-diesel made from soybean oil will not necessarily increase the price of soybean meal. Meal is the by-product after the oil is extracted.

One indicator of the future price behavior of a commodity is the current estimate of ending reserves. In the case of oilseeds, (soybeans are the biggest percentage of world oilseeds) world reserves grew steadily until this year. After the land grab by corn, the world ending inventories are now declining. Soybean prices can therefore be expected to rise.

World Ending Inventory Of Oilseeds



What is to be done?

Corn

Corn seems likely to be headed for a permanently higher price. Instead of averaging \$2 per bushel (\$80 per MT) on the farm in the US as before, corn is likely to average \$3 (\$120 per MT) in the next few years. In my opinion, corn users should take advantage of any opportunity to hedge or buy corn at less than the equivalent of \$3.50 per bushel (\$140 per MT) in Chicago for minimal downside risk and high upside potential.

Corn may spike to record prices at some point in the next few years, (above \$6 per bushel or \$240 per MT) if the heavy burden of corn use for ethanol use combines with a drought or other weather problem to cause reserves to plummet. The likelihood of corn prices returning to \$2 per bushel (\$80 per MT) appears to be slim.

Soybean Meal

Although soybean meal will fluctuate less violently than corn, it will rise in sympathy with corn prices because high corn prices shifted millions of acres from soybean to corn production.

Soybean meal (SBM) in Chicago was as low as \$160 per short ton (\$176 per MT) last year, a bargain. It is now \$120 higher at \$280 per short ton. In the next few years I would expect the middle of the range for SBM to be \$225 per short ton. Therefore any price of soybean meal less than the equivalent to \$225 per short ton in Chicago (\$248 per MT) would appear to be deserving of the attention of hedgers. Price spikes by soybean meal will occur in concert with corn and other grains.