Commodities Monthly Roundup -- December 2010

Market Highlights for November: At this time last month, we wrote that the markets were in store for a substantial correction, which we thought would set in after the Fed's QE2 decision and the Congressional elections, both of which we suspected were amply discounted in the price run-up leading up to these events. As it turned out, we did get our correction, but it was not because of the reasons cited, nor did it set in as imminently as we were expecting. Instead, the CRB index continued to push higher during the first two weeks in November before finally retreating in the second half. (See circled area in our chart). The triggers came from three variables, only one of which was somewhat predictable. In this regard, following October's interest rate hike, the Chinese continued to tighten their monetary base by raising reserve requirements on both the 10th and the 19th of November. Importantly, they also did not discourage further talk that another interest rate hike might be in the cards. The authorities are simply not seeing any meaningful slow-down in the country's heady rate of growth, and are also understandably alarmed by inflation readings that are approaching two-year highs. In fact, the inflation issue was serious enough for the country's president, Hu Jintao, to take to the airwaves in mid-November and reassure the public that his government was doing all it could to deal with rising prices. Surprisingly, he left out the details, leaving the Chinese equity markets in an even more weakened state. On November 12, the Shanghai Composite lost 5.2% for its biggest daily loss since August of 2009 and proceeded to lose another 5% over the next three days (following the speech). There were sharp declines in commodity markets as well, pretty much marking the top -- at least for now -- of an uninterrupted run that first started back in late August.

Chinese macro developments dovetailed an unexpected "financial unraveling" in Ireland, where the government was left scrambling to raise capital for a number of state-owned banks experiencing liquidity issues. Interestingly, the Irish crisis differed from Greece in that the ECB was a willing lender, but found that it could not advance any money until the Irish government formerly asked for it. It took more than 10 days (amid much market angst) for the Irish to finally throw in the towel, and admit they did not have the resources to shore up their banks. In fact, just as we were preparing this note, the final terms of the deal were struck over the weekend. An EU-IMF loan facility for €89 billion was approved, of which €10 billion was made immediately available to state-backed banks. Another €25 billion will remain in reserve, while the rest of the money will be used to cover Ireland's deficits for the next four years. EU negotiators also gave Ireland an extra year -- until 2015-- to reduce its deficit to 3% of GDP (the eurozone limit) from the whopping 32% level it is now at. All this help does not come cheap-- in addition to a loan rate north of 5%, Ireland must deploy its previously off-limit pension cash towards the bailout, meaning that the country will contribute some €17.5 billion towards its own rescue. In the meantime, Portuguese lawmakers offered a tough 2011 budget to help the country cut its deficit to 4.6% of GDP next year from 9.3%. In Spain, the central bank demanded greater disclosure from local banks and

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announced plans for new stress tests to show that its financial institutions could indeed absorb a "problematic exposure" of some $240 billion in souring construction and real estate loans. Earlier, the Spanish prime-minister taunted the markets, bluntly warning investors "who are short selling Spain" that they were going to get burned. The jury is still out on that call, and in fact, the response to the Irish rescue so far has not been that encouraging. The Euro is now at $1.31, down on day, while the risk premium investors are asking to hold Irish, Spanish, and Portuguese bonds over German paper have fallen only slightly from last week's levels.

If all this were not enough, markets were further rattled in late November by the unpredictable North Koreans, who decided to protest South Korean drills taking place on an island close to their border by shelling the place, killing two in the process. Tensions in the region manifested themselves in a stronger dollar, and things remain on edge this week as joint US-South Korean naval exercises get underway.

Outlook for December: Although we did get our correction this month, we still would not be buying the dips here, as we think the selling has more room to run. For one thing, the European situation is still far from over, since if Spain and Portugal now become "next", we could see further pressure on the Euro. In fact, we would not be surprised to see the Euro sell off to $1.28 by year-end, if indeed these two countries start to wobble, forcing the authorities to begin the torturous work of cobbling yet more rescue packages.

Upward pressure on the dollar is also coming from strong US macro readings we have been seeing of late, particularly on the labor front. In this regard, we had a surprisingly strong 150,000 nonfarm payroll increase in October, while weekly initial claims readings dipped to a two-year low. Looking ahead, MF Global's chief economist, Jim O'Sullivan, is expecting a 200,000 nonfarm payroll increase for November, which likely will push the dollar even higher in the weeks to come, and possibly lead to more unwinding of the "short-dollar/long commodity" trade that has proved so popular among the fund community.

Although the likelihood of a stronger dollar is certainly a potential headwind for commodities, we think the Chinese macro situation is the more perilous variable for the bulls. The Chinese are on an indisputable path of having to tighten further, not only because of an unresponsive economy, but because the Fed's QEII program could stoke inflation even further. One way out, would be to let the yuan appreciate faster, but there is immense resistance to this move by the country's powerful exporters, so the authorities may have little choice but to move on the rate front. For what it's worth, analysts at nine banks surveyed two weeks ago by Bloomberg, predict that China will raise rates yet again by the end of December. In the meantime the Chinese are "shooting the messenger", raising margin requirements on a variety of commodities, and pressuring speculators to liquidate their positions. All this does not bode well for commodity prices going into the year-end, and we would therefore be reluctant to go long until a more meaningful correction sets in. Keep in mind that despite this month's sell-off, brutal as it has been in some sectors, the Reuters/Jefferies CRB index is pretty much unchanged on the month.
WTI NEARBY CONTINUATION
Crude oil prices hit two-year highs in late November, but prices retraced back to the $80 level during the second half of the month on account of the Irish debt crisis and the resulting strength in the dollar. However, over the last week, we have seen a bit of a disconnect set in between the dollar and WTI prices, with the strength in the greenback not exerting as much pressure as it did before. It remains to be seen how much longer this divergence will stay in place, but given crude’s relatively uninspiring fundamentals, and with OPEC likely going to stand pat at its December meeting, we find it difficult to see prices pushing past the old highs of $88.64, at least through year-end. Instead, odds are high that we could see another retest and possible breach of $80 support.

BRENT NEARBY CONTINUATION
Brent’s charts are pretty much mirroring what we are seeing in WTI, as prices raced to just under the $90 mark in early November before selling off sharply during the second half of the month. We now seem to have retraced more than half of this decline, but we have our doubts we will take out the recent highs prior to year-end. Having said that, Brent’s technical picture looks slightly more constructive than WTI’s, as it is benefitting from a favorable arb, which hit a two-year high of almost $3 in late November basis the spot contract. The arb has been strengthening on account of a well-stocked inventory picture in Cushing vs. what we are seeing in Europe, coupled with several force majeure declarations by a number of majors operating in Nigeria due to the increase in recent violence there.

RBOB NEARBY CONTINUATION
With the US driving season behind us, and gasoline demand still very sluggish, we thought we would see somewhat more pressure develop on RBOB going into November. Instead, the complex has been fairly resilient, although it has had trouble breaking out above $2.25 resistance basis the nearby continuation. Gasoline demand remains subdued, particularly compared to distillate offtake, and so should limit the extent of any aggressive upside push from here. In terms of support, we could see prices retrace back down to $2.10 in the event of a more significant correction.

HEATING OIL NEARBY CONTINUATION
Heating oil prices looked very strong early on in November, tacking on about $2.22 a gallon during the first half of the month, only to give back all these gains over the subsequent two weeks. Prices have since recovered somewhat, as the steady heating oil crack, coupled with strong distillate demand, is resulting in fresh buying coming in to support the dips. We like heating oil on a relative basis far better than gasoline in that in addition to strong distillate demand, the complex will shortly be heading into the seasonally strong winter quarter. Should a significant cold snap set in, we would not rule out an eventual test of key resistance at $2.50. Support is at $2.20.
### EIA/DOE inventories for the latest week

**Crude:** +1.03 MB (forecast -2.1 MB)  
(API: +5.2 MB)

**Gasoline:** +1.91 MB (forecast -0.6 MB)  
(API: -0.3 MB)

**Distillates:** +1.5 MB (forecast +0.4 MB)  
(API: -0.5 MB)

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*unrevised / **for week prior in bcf

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**Data Sources:** EIA/API; Charts prepared by MF Global©
**NATURAL GAS NEARBY CONTINUATION**

Natural gas prices have been doing nothing but heading lower for most of this year, but things took a bullish turn during November, as prices tacked on about $1/bcf over the period. Technically, key resistance at $4.20 was tested twice and taken out on the third attempt. As a result, we are seeing a modest breakout on the charts, and the current run could conceivably take us to between $4.80-$5.00, particularly as the complex heads into the seasonally strong winter quarter. Additionally, prices will no longer be weighed down by relentless inventory builds.

**CRACK SPREADS**

Crack spreads have remained elevated for much of November, particularly in heating oil, and we suspect they will remain that way going into year-end. However, given our somewhat restrained view on crude oil prices, we do not see a drastic push higher in either of the cracks, with sideways trading ranges likely to govern for the time being.

**EMISSIONS**

Emission prices have not been doing much this past month, increasing modestly from the €14.20 level to around €15. In the meantime, the EU announced that options for carbon allowances for the post–2012 period will likely not start in 2011, as further work is needed on the “infrastructure” governing such sales, an EU spokesman said. The EU will auction around 60% of the total number of permits in 2013, with this proportion increasing in the out years. The program for 2012 would include aluminum and chemical makers, and airlines. A price poll taken by Reuters expects 2010 EU allowance prices to average around €15.7, down from €15.9 in the previous poll.

**URANIUM**

Uranium prices continue to surprise to the upside, and have tacked on another $8 a pound in gains in just the last month alone. Spot demand remains rather brisk on the back of strong Chinese imports. In addition, ambitious Chinese plans to increase nuclear capacity remain in place, with the latest projections calling for the country to expand its nuclear power generation nearly eightfold from 11 GW to nearly 80 GW by 2020.
3-MONTH LME COPPER

Copper prices have had a particularly volatile month, with prices getting to a two-year high of $8966, before retracing all the way down to $7920, all in the span of one week. The recent correction was triggered mainly by Irish-induced strength in the US dollar and the relatively soft October refined copper import data coming out of China. In addition, and as we have outlined in our cover commentary, there remains legitimate concern about future Chinese macro policy, and whether the authorities will slow the economy down even further by taking more aggressive action on the interest rate front. In the Chinese physical market, our channel checks show there is some easing in end-user demand, as spot inventories remain plentiful, while discounts for imported material vs. futures continue to increase. Although copper’s fundamental backdrop remains quite bullish, with LME stocks continuing to fall just as another 2011 supply/demand deficit looms ahead, we suspect that prices have likely done too much too quickly, and would not be surprised to see a retest of the recent lows going into year-end.

3-MONTH LME ALUMINUM

Aluminum prices have retraced sharply from the $2500 level, which in our view remains key chart resistance. The complex continues to be weighed down by the large amounts of inventory in stock, both on and off exchange. Furthermore, while China has cut back some 1 million tons of aluminum production so far this year, the decrease is still not significant considering an overall production profile of some 16 million tons, with millions more tons of capacity that potentially could be turned on if the government allowed it. In addition, aluminum stocks on the Shanghai futures exchange are still quite high, and only marginally off the 496,000 ton peak hit in June of this year. Excluding Chinese production, things hardly look any better; total production in October was just under 2.1 million tons, slightly over both September and year-ago levels. In sum, we view aluminum as being a relative laggard going into 2011, and continue to advise forward hedge sales to be put on between $2500-$2700 basis three months LME.

3-MONTH LME ZINC

Zinc prices have fallen sharply in November, declining by some 20% from their $2600 high. We find that in metals like zinc, where the fundamentals are more bearish and show little sign of improving, corrections are frequently sharper and last longer than in complexes where the fundamental picture is tighter. Things hardly look any better for zinc going into 2011; the International Lead and Zinc study group is forecasting another 161,000 tons surplus for next year, this coming on top of the 233,000 ton surplus expected in 2010. These numbers should keep zinc prices under pressure, at least through the first half of next year, where we see a rough trading range of between $1800-$2750. One potential bright spot, is the fact that Chinese zinc production, while rising by a projected 4% next year, will be off the 15% growth rate seen in 2010.

3-MONTH LME LEAD

Similar to zinc, lead has been dogged by excess production, preventing stocks from declining. LME stocks are now just over 203,000 tons, up about 30% since the start of the year, and at their highest level in some eight years. Overall, the market is running at a slight 49,000 ton surplus in 2010, this according to the latest ILZSG figures, and a balance will likely prevail next year. Like aluminum, we are seeing a number of Chinese smelter closures, but these have not made a significant difference to the overall supply situation. In fact, these facilities could start up again if and when government-imposed power restrictions are lifted. In the meantime, we see an element of support set in over the market at least over the next month or two given the seasonal boost that lead usually receives over the winter months. In addition, Chinese car sales remain robust, although they are not running at the heady pace evident earlier in the year. Prices should trade between $2120-$2500 for the balance of the year, with the trading range shifting slightly higher in 2011.

Source for charts: Bloomberg
3-MONTH LME NICKEL
Nickel has been a relative laggard compared to some of the other metals during the month of November, although it has recovered some of its steep losses over the last week. LME stocks remain high, and are keeping the rallies somewhat in check. Surprisingly, the market did not react favorably to news out during the middle of November that Vale would be postponing its Goro start-up date to 2013 (although the company did say that it would start shipping minimal amounts of ore from the facility). Other producers are on track for production gains next year, but none of them approach anything close to the 58,000 tons of metal that the Goro facility could potentially produce. We see nickel prices trading between $20,500-$24,500 between now and the end of the year, at least until the markets get a better handle on how first half 2011 stainless demand will be shaping up.

3-MONTH LME TIN
Tin prices have had an incredible run over the last two months, so it was inevitable that some sort of a correction would finally set in. We never did hit our $30,000 a ton target in this latest run, although we did get to a high of $27,500. However, heading into next year, tin’s supply/demand profile looks very bullish, with an 8,000 ton deficit expected, this on top of the 24,400 ton shortfall projected by ITRI for 2010. Should the supply side remain as unresponsive in 2011 as it has been so far this year, we would not be surprised to see a $40,000 print on tin given the low level of stocks and the fact that only a handful of producers have the potential to turn on production. As of now, many are simply not in a position to do so.

LME STEEL
Billet prices have remained relatively flat this past month, and did not see the same degree of weakness that was evident in non-ferrous metals. We note from our chart alongside that prices are currently hovering around the $500 a ton mark, but we suspect we could drift slightly lower heading into the year-end. We say this in view of the fact that steel output continues to run at a very strong clip, this despite a number of announced cutbacks. China’s crude steel output, for example, is expected to finish 2010 at a whopping 624 million tons, up 8.2% from the previous year. Apparent demand for steel is projected at 536 million tons, about 31 million higher than last year, but leaving a substantial surplus in place nevertheless. Chinese steel demand could be under further pressure in the months ahead, as the government intensifies pressure on the country’s real estate sector, by raising reserve requirements on banks, increasing collateral on loans, and likely putting through yet more interest-rate hikes. Construction already accounts for about half of the country’s steel demand, and so any slowdown here would be a significant game changer.

IRON ORE
Iron ore prices bucked the generally weaker trend we saw in a number of base metals in November, with prices rising by about 10% over the period. Two long-serving and respected iron ore executives that our Sydney-based equity mining analyst – Andrew Gardner – met recently, both described the current iron ore outlook as the most positive they have seen in all their 20+ years in the business. A large part of the story is clearly centered on the supply side, where 25% of India’s exports are still tied up by a government ban. Although renewed weakness in the rest of the base metals complex could ultimately impact iron ore, the two groups have a tendency to decouple, and so we still remain positive on the sector over the short-term. Spot deals are being reported at about $170 a ton as of this writing, and these levels are being achieved despite the fact that we have not yet hit the peak restocking period that typically takes place during the February–May window. (Contribution by Andrew Gardner).
GOLD COMEX NEARBY CONTINUATION

Gold had an erratic month in November, hitting a record high early in the month, but then retracing during the second half on account of a stronger dollar. Lately, gold seems to be decoupling from the dollar, with the two rising in tandem. It seems both complexes have turned into “safe-haven” plays, with the dollar benefiting from the Irish crisis, while gold staying steady after fighting broke out on the Korean peninsula. Moreover, there is no letting up in investment demand for gold, with ETF’s now owning almost 2100 metric tons of the precious metal, equivalent to roughly 9 years of US mine supply. However, there are indications that retail demand is flagging on account of high prices. Having said that, we remain friendly on gold going into 2011, as we think the precious metal is still relatively cheap on an inflation-adjusted basis. Shorter-term, the next month or two might be sloppy, as the European debt crisis, which we think will intensify, will likely channel money into the dollar as opposed to gold. It will only be when the dollar starts to weaken will we see gold prices move up more convincingly.

SILVER NEARBY CONTINUATION

The silver market very much followed gold’s trajectory over the past month, as it also hit a record high at one point in November before selling off sharply during the middle of the month. Prices have since recovered to about $27.50, although there is a gap on the charts that needs to be filled around $25. Jewelry demand remains fairly steady, as high gold prices seem to be nudging more retail customers into choosing (or adding) silver to their purchases.

PLATINUM NEARBY CONTINUATION

Platinum hit a record high 2010 high of just over $1800 a ton in mid-November, but then retraced sharply, falling to about $1640 a ton during the second half of the month. We have since recovered somewhat, but the complex could do much better going into 2011. For one thing, there is very little new production growth expected next year, as cash costs remain quite high, and may not provide enough incentive for further capital investment. On the industrial side, strong auto demand, particularly in Asia, should keep offtake brisk. In addition, platinum is the only precious metal that has yet to take out its 2008 high, so certainly on that basis, we see room for further gains. Short-term however, and at least through the year-end, the complex will likely trade in sideways fashion, with the recent high likely remaining unchallenged, while a substantial correction could conceivably take us to $1500 an ounce.

PALLADIUM NEARBY CONTINUATION

Palladium had a stellar month in November, hitting a 10-year high in the process before getting caught up in the general downdraft that knocked off 15% off prices. The market has since regrouped, and our guess is that we will likely move higher going into 2011. For one thing, palladium is trading at a substantial discount to platinum, and so should continue to siphon off market share, particularly in some auto applications. Production of palladium, currently estimated at about 7.14 million ounces, is projected to show no growth next year, and in fact, has basically been flat since 2008. There are also rumors that a program by Ford to sell a 1.8 million pound stockpile has come to an end, and similar talk abounds that Russian stockpiles have also been depleted. On the demand side, consumption is estimated to have risen by 11% this year from 2009 levels, largely on account of very strong Chinese offtake, and will likely grow at a similar rate next year.

Source for charts: Bloomberg
CORN NEARBY CONTINUATION
Corn prices sold off sharply after poking above the $6/bushel level in early November. The USDA’s November 9th report triggered a substantial sell-off, as the revision in corn yields to 154.3 bpa’s was in line with expectations, and did not surprise the markets like previous reports have. Prices have also been negatively impacted by increasing concern about the slowing pace of export demand and the strengthening dollar. Nevertheless, we continue to have a moderately bullish view on corn given its fundamentals, but suspect the markets will likely be more influenced by outside forces until early next year when the battle for acreage takes center stage. Charts show that a gap around the $5 has been filled, possibly helping prices make some headway to the upside. With the US crop mainly being harvested, focus is now on South America, where much of the growing area is said to be suffering from a lack of rain.

WHEAT NEARBY CONTINUATION
Wheat prices soared to a four-month high in early November, but like the rest of the grains, got caught up in the dollar-induced correction that took prices all the way down to $6.20. The complex has started to consolidate since then, and we are now hovering around the mid-$6 range in relatively restrained fashion. It is possible that wheat could see somewhat more volatility come January, when we get the USDA’s winter seeding report. The report might show lower planted acreage than previously anticipated given the dry conditions in the winter wheat belt. In the meantime, wheat will likely continue to follow corn and soybeans over the near-term, as its own fundamentals remain relatively weak in comparison. We see support at the recent low of $6.20, with resistance at $7.00.

SOYBEANS NEARBY CONTINUATION
Similar to wheat, soybean prices retraced by some 10% since hitting 14-month highs in early November, but the intermediate uptrend line remains intact. Although the November 9th USDA report was fairly bullish, its impact was overwhelmed by the strengthening dollar and speculative liquidation. In addition, news that the Chinese were planning to release some of their domestic soybean reserves into the market also hit prices hard. On the bullish side, the USDA is projecting ending stocks falling by another 80 million bushels to 180 million bushels on the back of increased Chinese export projections and a further dip in US crop yields. Moreover, there remains lingering concern over the South American crop, where rainfall was below average in both Argentina and Brazil for much of October and November. We expect soybeans to likely outperform corn and wheat until the market gets a better handle on what is happening with South American supplies, and see prices taking another stab at the early November highs of $13.50. On the downside, there is good support at $11.80.

FFA
FFA prices have remained rather depressed for much of November, with most rates continuing to trend lower. The beginning of November saw a rally in physical cape quickly reverse into a steady decline. Peaking at $46,434 at the end of October, it has since declined to $29,333 as of writing. Futures have followed, and the entire curve has moved downwards to reflect the lack of confidence. The decline has been most pronounced in the front part of the curve, with December trading down from $34469 to $26766, and the ratio declining from 1.72 between cape Panamax to 1.43 for December. This is very much a case of cape weakness vs. Panamax strength, as Panamax has suffered a more modest decline during this period. With the holiday period nearing, it is likely that the shipping complexes will continue to soften or plateau until the New Year. 

Contribution by Matt Duggan from our London office.

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Source for charts: Bloomberg
SUGAR NEARBY CONTINUATION
We have seen intense volatility in the sugar complex this past month, with prices racing to a 29-year high of around $.33 a pound, only to fall sharply to the $.2550 level in just a matter of two days. The initial run higher was attributable to increased concern over projected first-quarter Brazilian production, along with uncertainty over the Indian export picture. India is intent on rebuilding its domestic stockpile after suffering through two straight seasons of poor cane harvests. Looking ahead, the sugar stock picture looks extremely tight, and this bodes well for prices going into 2011, particularly if weather continues to be an issue. On the downside, prices are experiencing good support around the $.2550 mark.

COCOA NEARBY CONTINUATION
Cocoa prices have been relatively restrained over the past month, and have not experienced the sharp gyrations that have been evident elsewhere. We suspect that this is because of the fact that the run-up to the critical Ivory Coast elections seem to have been largely peaceful (at least for African standards), and were concluded just as we went out with this note with minimum disruption. With the elections now heading into a run-off stage, and a decent harvest coming through from other countries, we would not be surprised to see a drift lower to the bottom end of the trading range, as evidenced on our chart alongside. However, the Ivory Coast remains a critical pivot point, and should take time to settle, so we will likely see protracted declines remaining in check.

COFFEE NEARBY CONTINUATION
After coffee prices set a 13-year high in early November, prices retraced during the second half of the month, but the selloff was not as sharp as what we saw in a number of the other tropica, like sugar. Prices now seem to be regrouping and again pushing towards recent highs on concern about tightness in near-term Arabica supplies. In addition, overall stocks are minimal, with exchange holdings dropping to a 10-year low. Although harvests in major Central and South American regions are now in full swing, there is concern about conditions in other producing countries, like Vietnam, where there are reports of rain-induced delays to the crop. Constructive chart patterns suggest that we could climb somewhat higher from here. In addition, we are somewhat encouraged by the fact that the recent correction was relatively shallow.

COTTON NEARBY CONTINUATION
Cotton prices have seen a spectacular boom and bust in November, racing from about the $1.20 mark to $1.58, only to sell off to $1.13 as of this writing. We were not surprised by this correction, as the complex was doing too much, too quickly, and was extremely overbought technically, with RSI's frequently running in the 90's. Cotton's initial run was triggered by a disappointing Chinese harvest, whereby only 40% of the national crop had been harvested by mid-October compared to 60% in a typical year. In the meantime, US stocks have been run down as farmers switched to grains. In addition, earlier this month, the USDA estimated that cotton inventories fell to 2.2 million bales, the lowest since 1925. The selling got started when the Chinese government pressured futures longs on the cotton exchange to liquidate, while publicly initiating an anti-inflation drive by targeting “commodity speculators”. With much of the froth now exiting the market, and charts looking pretty dreadful to boot, we would not be surprised to see a retracement back to the $1.00 mark, which was the initial breakout point. The $1.35 level marks resistance.
EURO
After several months of relative stability, the Euro has again blinded the markets, and this time it was Ireland that fell upon difficulties. After a protracted period of negotiations, made all the more complicated by Ireland’s reluctance to borrow from the ECB facility, a $115 billion loan package seems to have been put in place. However, the euro continued to decline, as investors were viewing Ireland as only the tip of the iceberg, and saw continued funding issues in other countries, notably Spain and Portugal. For their part, the Portuguese denied that they were seeking a bailout, while the Spanish prime minister warned shorts about losing money. Germany also had to deny reports that it was contemplating increasing the ECB stabilization fund, but despite all this, the euro sank to a two-month low of $1.31 as we went out with this note. We suspect that there will be more turmoil ahead, and are looking at a $1.28 target by year-end. It will likely take this degree of weakness to finally convince the authorities to buy some of the paper that the markets are reluctant to hold.

YEN
The Japanese yen has weakened recently, as it has not been able to escape the upward thrust of the dollar. In addition, the fighting that broke out on an island between the two Koreas likely weakened the yen as well, since the tensions were too close to home. Macro news has not been that constructive either—Japanese growth is expected to slow in the coming months after a strong acceleration in the third quarter, which itself was artificially fueled by a number of government incentive plans. The export sector has also been slowing down of late, and we have yet to see any clear formulation of policy by the new government. We could see the yen decline somewhat further to the 85-86 level by year-end, especially if euro funding issues come to a head, as we expect them to.

STERLING
Sterling has weakened against the dollar, falling from about $1.63 to currently trade at $1.56, as investors worry about UK banking exposure to Ireland, estimated to be some $130 billion. The stronger CPI numbers (around 3.2% annualized) have also raised some alarm given that this is outside the Bank of England’s target zone. On the positive side, retail sales came in at the strongest level in some three months, although we feel that this likely has to do with purchases being brought forward given the plan to raise the VAT. Charts suggest that there is likely further weakness ahead, possibly to the $1.53 level, last reached in September. On the upside, resistance is heavy at $1.61-$1.63.

DOLLAR INDEX
The dollar index has strengthened considerably after hitting a 10-month low in October. We have outlined our views on the dollar in earlier commentary, and would just repeat what we said previously, namely that the greenback is likely poised to push higher, both on the back of continued euro zone worries, as well as lingering tensions between the two Koreas. The dollar index got to a high of 89 back in late May, and although this could be the next logical upside target, we suspect this particular rally will be much more modest, and likely top out around the 84 mark.
S&P 500
We were expecting the S&P 500 to sell off sharply shortly after the Fed’s QE2 announcement and the Congressional elections, both of which we thought were amply discounted by the runaway markets at the time. However, stocks continued to gain ground after these two events, and it was not until the Irish crisis broke that the markets finally saw a substantial correction set in. Since then, relatively better macro news out of the US is keeping the declines somewhat in check. Particularly heartening, is the decent bounce we saw in the October nonfarm payroll report, coupled with a sharp decline in weekly initial claims data, both indicative of a labor market on the mend. Technically, the S&P charts do not look as constructive; the fact that we failed to break decisively above 1220 -- the April high -- signifies a possible double top, and suggests that we could see a further decline to about 1140, a 50% retracement of the September to November move.

10-YEAR NOTE
We are surprised by how quickly the price for the 10-year note has deteriorated over the last month, as few were projecting yields close to a 3% so soon. The decline is also surprising in that it took place shortly after the Fed’s QE2 announcement, which normally should have been a bullish development for the market. Better macro data out of the US also pressured prices lower, with strong labor data being particularly bearish for the complex. It is difficult to project the current rate trajectory at this particular juncture; the last time the European crisis erupted, we saw a sharp slowdown in US growth, leading to a substantial rally in 10-year paper. It remains to be seen whether we follow the same route this time around, but our guess is that the US economy is gaining enough traction on its own for yields to push towards the 3.5% mark by the end of Q1 of next year.

Source for charts: Bloomberg

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