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Commodities Monthly Roundup -- July 2010

Trading Highlights for June: We experienced as much stomach-churning volatility in June as we did in May, best seen from the Reuters-Jeffries CRB index plotted below. The chart shows us that commodity prices moved up sharply over the second half of June, only to give up about half its gains later in the month before starting to recover again. Whereas the euro was the prime selling trigger in the markets earlier in the quarter, it took much of a back seat this past month, and was, in fact, an impressive winner, rallying from a low \$1.1877 to a little under \$1.27. Easing concern about sovereign debt issues, the placement of the ECB's stabilization package, and proposed bank stress tests, all helped allay some of the concerns evident earlier. Also somewhat of a relief, was the fact that a key refunding deadline for European banks expired without causing much of a stir. In this regard, the European Central Bank said it lent banks €131.9 billion for a three-month period, this after their one-year loans were no longer renewed. The renewal amounts were much less than economists had forecast, and a clear sign that funding needs were not as pressing as first feared.

TABLE OF CONTENTS	
Energy	3
Energy Inventories.....	4
Energy, Emissions, Uranium	5
LME Metals.....	6
LME Metals, Steel, Iron Ore	7
Precious Metals.....	8
Grains, FFA.....	9
Tropicals.....	10
Currencies.....	11
Financials	12

Of course, this being the markets, there was always something new to fret about, (apart from the World Cup, which provided a welcome relief) and thus, fading concern over the Euro was replaced by worries over slowing growth. In the US, factory output expanded for the 11th month in June, but it was at a slower pace than the month before. In addition, pending home sales --now no longer propped up by government incentives-- declined, as did construction spending. Consumer confidence readings also plunged sharply this past month, (as did consumer credit), while the labor market continued to struggle. This was evidenced by US employers cutting 125,000 jobs in June, the most since October. Much of the loss was driven by the termination of 225,000 temporary government census jobs, and while private businesses added a net total of 83,000 workers, it was not enough to offset the overall decline. Unemployment dropped to 9.5% from 9.7%, but this was deceptive, as more than 650,000 people left the labor force altogether.

Arguably, markets have by now grown accustomed to the hot and cold numbers coming out of the US, but indications of a possible slowdown in China did cause quite a bit more trepidation, particularly in the late-June and early-July period. In this regard, the latest Chinese manufacturing index fell to 52.1, still in expansion mode, but off from 53.9 seen a month earlier. In addition, we had reports of slowing real estate sales, a slight decline in home prices (for the first time in more than a year), and a sharp slowdown in the growth of automobile sales. Reports from India and Taiwan reflected similar declines in manufacturing, while exports out of South Korean and Indonesia also lagged May levels. Out of Europe, Eurozone June manufacturing slowed to its weakest growth rate in four months.



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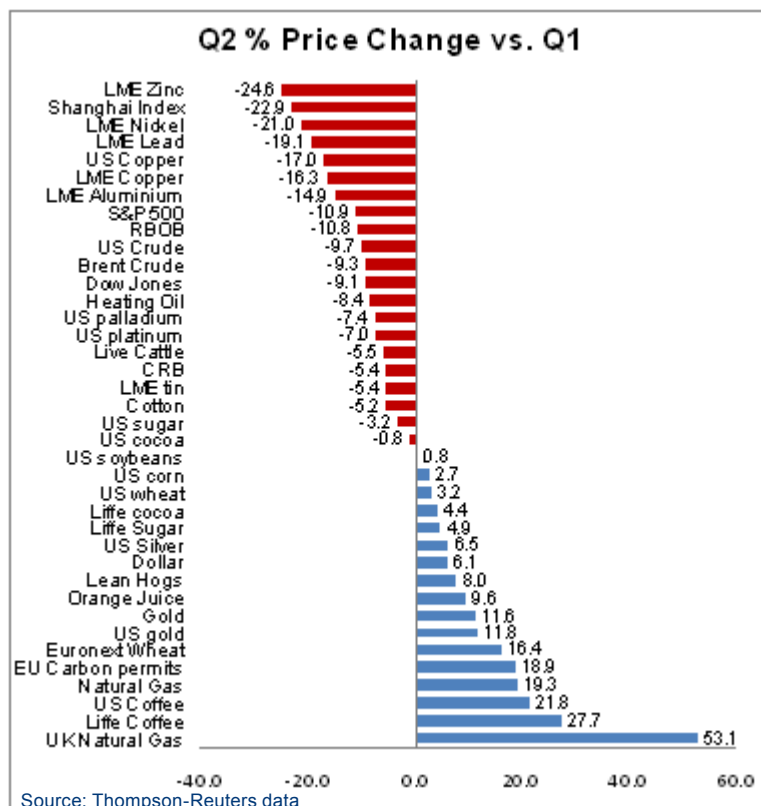
Outlook: Despite growth readings down-shifting a gear or two, we have been seeing a relatively decent recovery in the markets over the past two weeks. So far, this fits well with the theme outlined in last month's commentary where we called for markets to stabilize within broad trading ranges over the next two months. We think fears about a possible double dip contraction -- most visible last month -- are misplaced, and would instead suggest that the softer macro data we are seeing from a number of countries, (including China), is a normal pause in the expansion cycle, and therefore should not result in a breach of the June lows. More importantly, a number of commodity markets, particularly in base metals, have already corrected sharply, and may have arguably discounted the slowing growth cycle we seem to be in. In addition, from both the ferrous and nonferrous space, there is increasing talk of production cutbacks. Finally, stock levels have been falling in all six of the LME metals we follow, (albeit in varying amounts), further evidence that demand has remained intact.

As an aside, we do not think rapid rates of growth are necessarily good for the markets, as it will only fan fears of eventual central bank tightening and concern about a hard landing, particularly out of China. For their part, Chinese authorities remain busy tinkering with individual sectors of the economy in an effort to slow things down without raising rates. We will see how they have fared when more data comes out this week, including 2nd quarter GDP and industrial production readings. The authorities did think somewhat out of the box last month, allowing for a very slight revaluation in the yuan (+.8%). Although the step-up was rather timid, it was a move in the right direction, and should provide a non-inflationary boost to local consumption. More importantly, it did stave off a currency manipulation charge from the US Treasury Department, something that otherwise would have undoubtedly destabilized a number of markets.

An important source of stability in the commodity markets -- and one which we think will continue to manifest itself through July and into August. -- is the fact that US equity markets have recovered nicely, notching up their strongest gain in almost a year last week. Investors seem to be putting aside concerns about slowing growth for now, focusing instead on second-quarter earnings, which should be up a solid 27% year-over-year and could very well exceed this number as well. (Alcoa started things off well on the 12th of this month, beating revenues despite lower aluminum prices).

Upcoming items to look out for over the next few weeks are the Chinese macro numbers, as well as the results of the ECB bank stress tests out on July 23. We should note that US equity markets rallied when the Treasury was in the midst of its stress tests on US banks, and so we could have a similar situation this time around. However, the ECB stress tests need to be realistic; glossing over problems or, alternatively, extracting onerous haircuts on capital could just as easily send the markets reeling. The authorities will therefore have to strike the right balance, while also striving for transparency, but if we can safely navigate past this critical date, markets should breathe a little easier going into late-July August period.

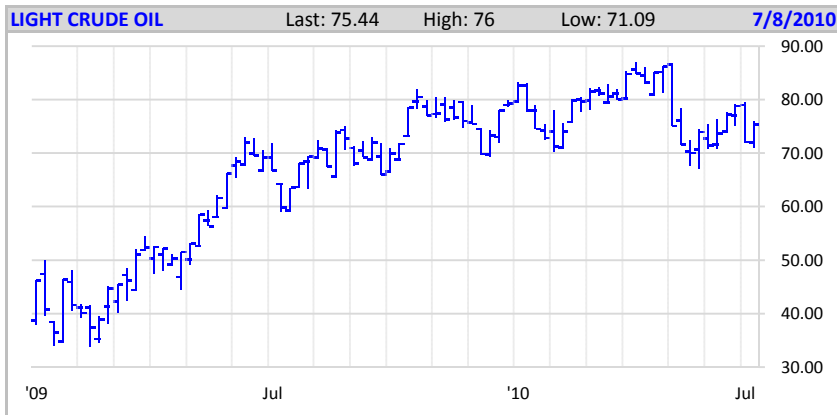
In the hedge fund world, assets under management at index-tracking funds rose 71% to \$111 billion by the end of May, this according to the latest data from Barclays Capital. Commodity hedge funds lost 4.9% in the first five months of the year (on average) after declining by about 3% in 2009, this according to Hedge Fund Research. Even passive money did not fare that well, with the S&P GSCI Total Return Index down some 12% from January through May. Our take is that most hedge funds are keeping their powder dry, and not over-committing at this point, best evidenced by the sharp declines in net noncommercial positions we have seen in a number of complexes.



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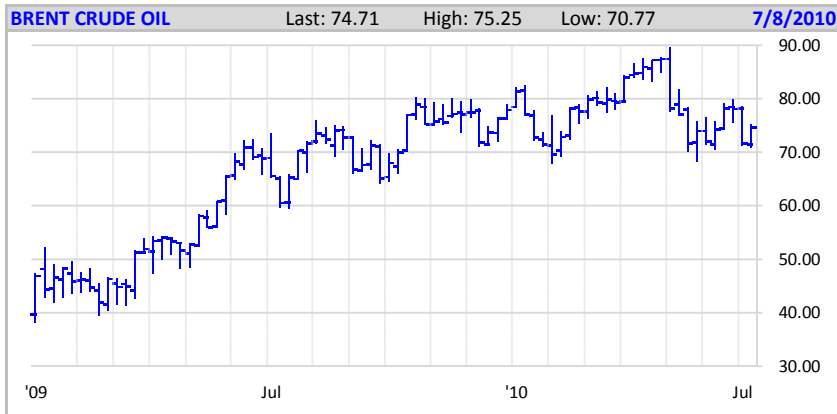
WTI NEARBY CONTINUATION

For the moment, crude oil prices still seem to be stuck in a trading range, and there is no compelling reason for a breakout in either direction. The downside is being held in check by the fact that we are entering a hurricane season that looks to be more troubling than what we have seen in prior years, while US demand is also showing clear signs of improving. However, while demand is in recovery mode, it is simply not strong enough to make a dent in overall inventory levels, which continue to remain comfortable, as our charts on the next page show. At this stage, our likely bias remain slightly higher; with 14-23 storms expected in the Gulf over the next few months, we would be reluctant to go short, comfortable as the supply/demand picture seems to be. Look for support around the \$71, with any breaches below the \$70 level being short-lived, while on the upside, we would not rule out a push into the low \$80 range on hurricane-related jitters.



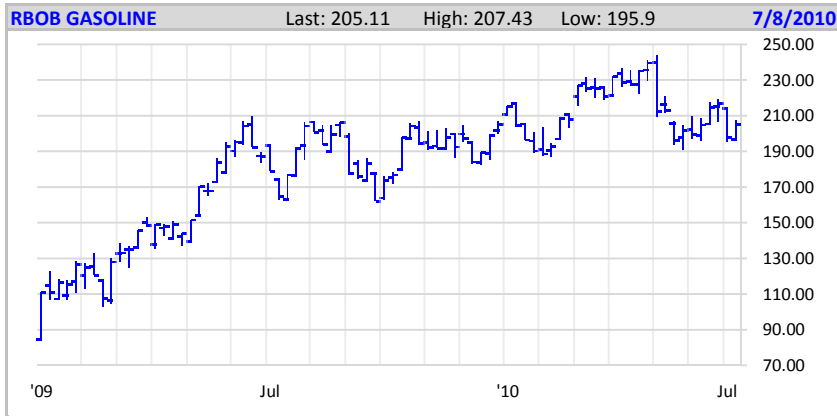
BRENT NEARBY CONTINUATION

Brent prices have exhibited a similar pattern to that of WTI above, with values finishing the month pretty much unchanged. There is good support on the charts around the \$70 mark, while \$80 seems to be capping the upside. The arb between Brent and WTI seems to have shriveled, and the fact that crude oil inventories in Cushing seem to be trending lower should prevent it from flaring out any time soon.



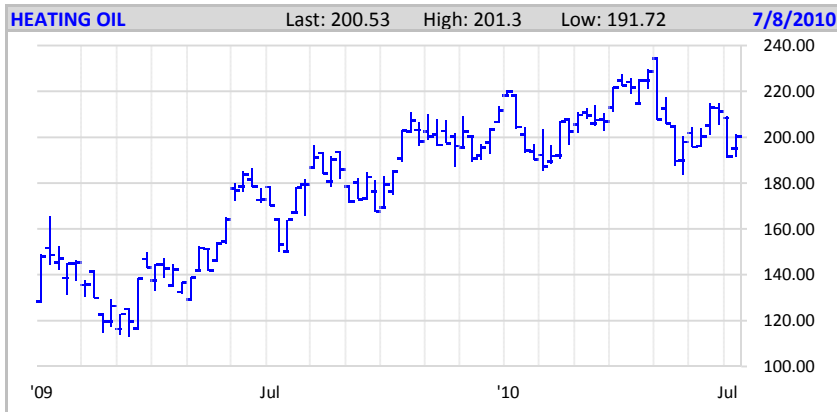
RBOB NEARBY CONTINUATION

We are seeing very uneventful trading in gasoline with a trading range of \$1.95-\$2.20 dominating over the last six weeks. However, US demand for gasoline has been improving steadily over the last few weeks, although its year-over-year increase has not been as impressive as that of distillates. As is the case with crude, we would be reluctant to get too short of RBOB over the summer months given the plethora of hurricanes that are expected. If something threatening breaks out on the weather front, a retest of the May high of \$2.45 cannot be ruled out.



HEATING OIL NEARBY CONTINUATION

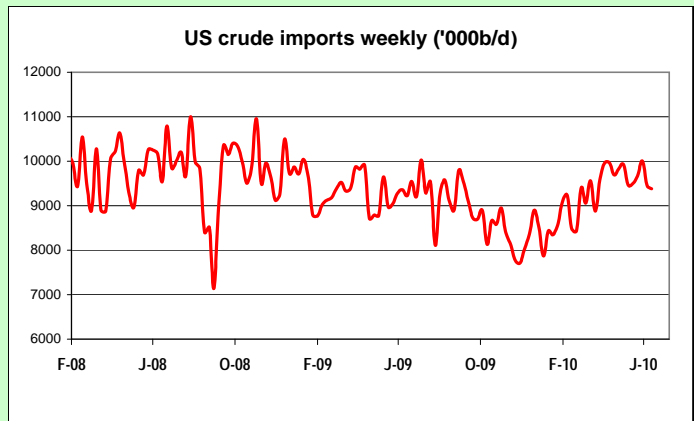
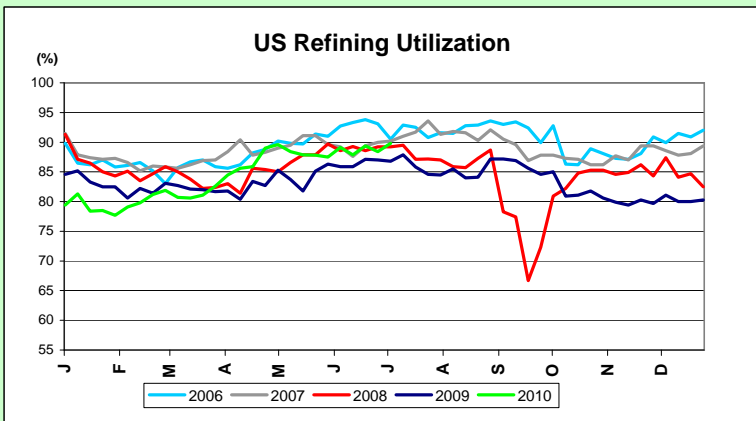
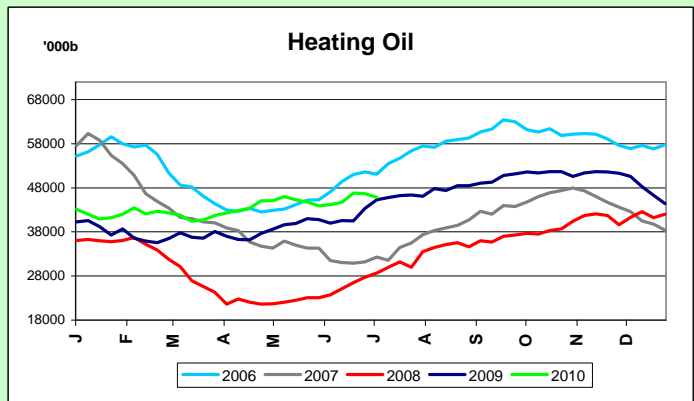
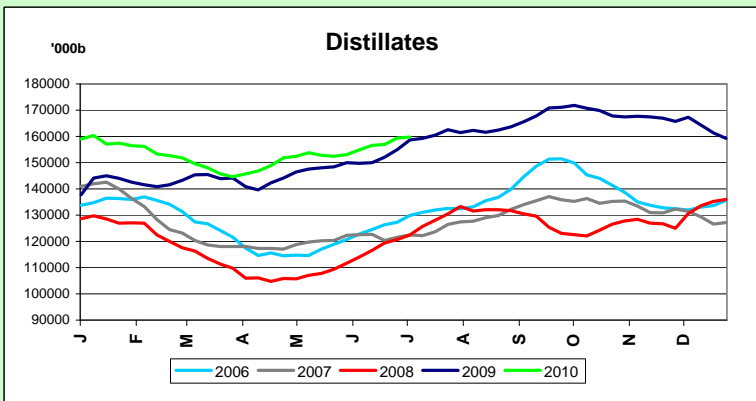
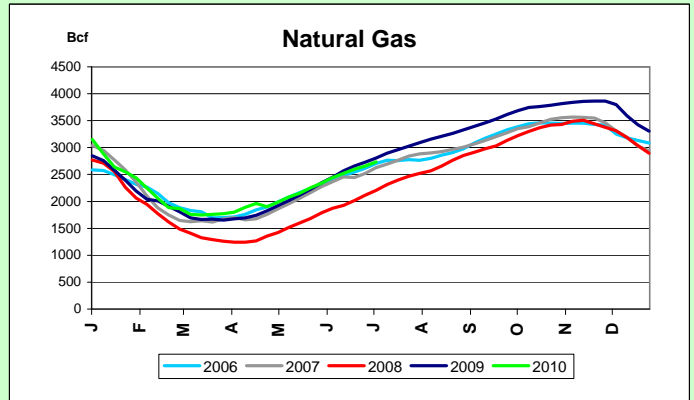
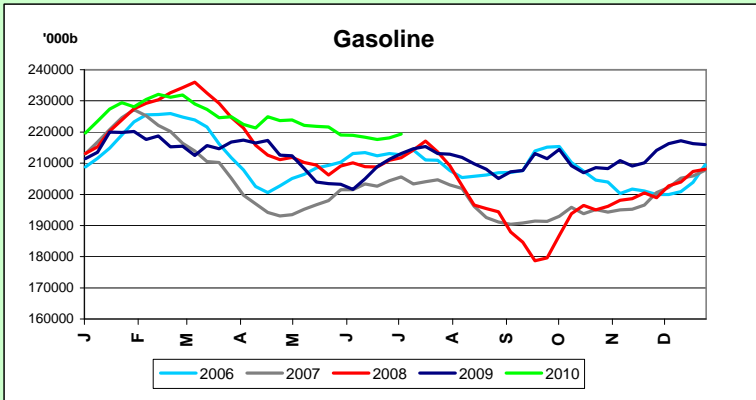
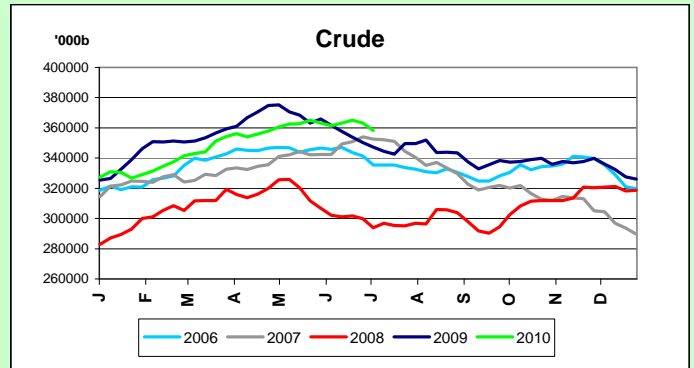
Heating oil has been surprisingly weak given the sharp rise in distillate demand, (up a whopping 29% year-over-year according to the latest EIA report), but this is likely due to the fact that the stronger offtake has yet to make much of a dent in inventory levels. We see good support around the \$1.90 level on the charts, with resistance around \$2.1750.



EIA/DOE Inventories as of July 2

(MB)	Current week	Previous week	Year ago	Change from last	
				Week	Year*
Crude	358,200	363,100	347,300	(4.9)	10.9
Distillates	159,700	159,400	158,700	0.3	1.0
Gasoline	219,400	218,100	213,100	1.3	6.3
Heating Oil	45,900	46,700	45,300	(0.8)	0.6
Natural Gas**	2,733	2,655	2,805	78.0	(72.0)
Imports	9,380	9,450	9,220	(70.0)	160.0
Capacity Util (%)	89.8	88.4	86.8	1.4	3.0

*unrevised / **for week prior in bcf



NATURAL GAS NEARBY CONTINUATION

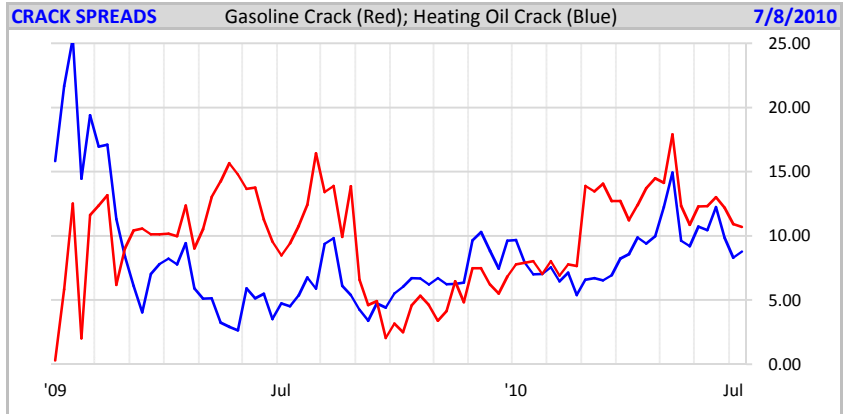
Natural gas prices spiked over the first two weeks of June, getting to a peak of \$5.20 before receding to the mid-\$4 mark at the time of this writing. Prices have struggled on account of a growing, but still sluggish US economy, near record high gas production, and comfortable inventories, (only 1% off last year's record high). We do not see any major breakout one way or another for the time being, but would be inclined to gravitate to the long side, particularly on any declines to between \$4-\$4.20.

...



CRACK SPREADS

Cracks have receded sharply over the past six weeks, particularly in heating oil, which is surprising given the relative resiliency in distillate demand. Nevertheless, margins are still relatively profitable, and well above where they were at this time last year, prompting refiners to continue to crank out units. Despite US demand increasing, refiners have been more than able to keep up, as evidenced by the fact that inventories have barely budged.



POWER

Both EUAs and CERs have been trading within a €1 range, largely immune to movements in the oil markets. Interestingly, the spread between the Dec '10 EUA contract and the Dec'10 CER contract has remained above €2 for the last two months. With the takeover of Tricorona by Barclays now a certainty, Barclays may reduce some length in the physical CER book, and this may cause the EUA/CER spreads to remain high for some time. In addition, carbon allowances dropped to their lowest level in more than six weeks in early July, as German power prices declined. We do not expect to see much volatility in emissions for the balance of the year, as the EU mulls a new legislation cap from 2013, while also having to decide how carbon permits will be auctioned off. Here in the US, any chance of any meaningful legislation looks slim before the November Congressional elections. Amid the news vacuum, we look for continued erosion into the summer months. *Contribution by Akshat Jaswal from our Singapore office.*



URANIUM

Not much to say here; conditions are very quiet, with prices bumping along a bottom at just over the \$40 mark. The low level of price activity does not seem to be reflecting the fact that China is apparently buying unprecedented amounts of uranium, this according to a Bloomberg story out this week that cited the country's most recent purchase of more than 10,000 tons (over 10 years) from Cameco. China may also purchase about 5,000 metric tons this year, more than twice as much as it consumes, as it seeks to build stockpiles for new reactors. Further out, overall demand could rise to 20,000 tons a year by 2020, more than a third of the 50,572 tons mined globally. However, uranium has tumbled almost 70% since peaking at \$136 a pound in July 2007, stimulating a massive amount of supply. We can only surmise that, despite the Chinese buying, the market needs to see much more buying and a reduction of stockpiles before prices can push higher.



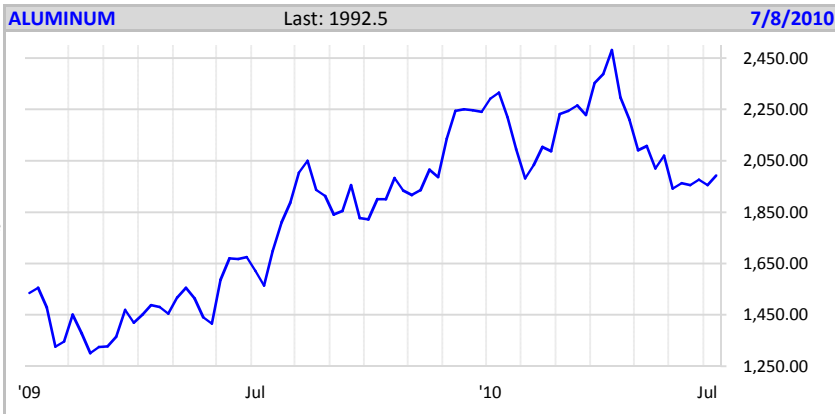
3-MONTH LME COPPER

We suspect the mid-June low of \$6035 should hold into the summer months, as we do not see conditions deteriorating to such an extent so as to trigger another major sell-off. For one thing, prices have already moved lower, arguably discounting the slowing growth scenario. Secondly, the euro has stabilized, removing a source of weakness that was evident in May and June. Finally, copper's fundamentals are looking less negative. Although Chinese June imports were 17% below May levels, year-to-date intake (at a little over 2.3 million tons) is practically unchanged compared to last year's blistering pace, while scrap imports are 17% higher year-to-date. More importantly, imports are not being picked up in visible inventories, as stocks in Shanghai have been falling of late, dovetailing a similar decline on the LME (off by some 100,000 tons since March). All this tells us that, barring imported metal going into hidden stocks or private stashes, actual demand for copper in China remains quite healthy, and this seems to be confirmed by the channel checks we conducted with some of our Chinese fabricators. More importantly, the latest ICSG report released in June shows 1st quarter 2010 world copper supply and demand moving into a balanced situation from the surplus evident in both January and February. We look for a trading range market in copper through August, between \$6000- \$7300, and expect the June lows to hold.



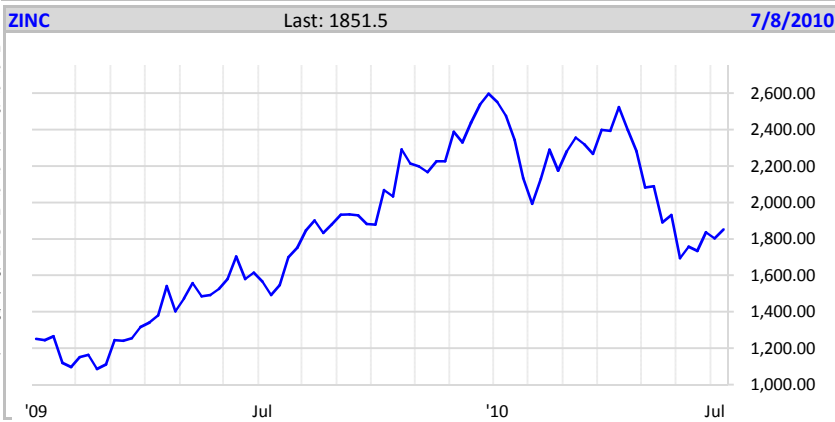
3-MONTH LME ALUMINUM

An overhang of about 4.4 million tons of LME stocks continues to weigh on the market, this despite a 220,000 ton decrease in January. We have been negative on aluminum for much of the past year, but given the extent of its recent decline, we think the market is approaching a more balanced situation, particularly if some producers now carry through and actually decrease production. In this regard, thirteen aluminum smelters in China's Henan province said they plan to idle a total of 700,000 tons of production in July because of low prices and high power costs. There is also evidence of retrenchment upstream, where Chalco has pulled out of a \$2.4 bln deal to develop a bauxite refinery in Australia. However, none of this is showing up in the numbers just yet – the IAI said that total May production was 2.06 million tons compared with 1.98 million tons in April and 1.96 million tons in May of 2009. Nevertheless, the likelihood of future cutbacks should provide a floor around \$1850-\$1900, a price point that is also being pitched as breakeven for many smelters. On the upside, a technical bounce could take us to \$2250 later in the year, a level that should be used as a selling opportunity, particularly if we see no evidence of cutbacks being put through.



3-MONTH LME ZINC

After putting in an early-June low of \$1577, zinc rallied to a high of \$1900 later in the month, but still has the dubious distinction of being the worst performer in the broader commodity index, losing 25% in Q2 after giving up by 7.2% in Q1. The complex continues to be weighed down by rising stock levels, (some 620,000 tons on the LME alone), further evidence that producers, despite talk to the contrary, have yet to cut back production aggressively. We suspect this will eventually happen, but certainly it has been slow going so far. Latest ILZSG data shows that the global zinc market was in surplus by 180,000 tons in the first four months of the year. Global refined zinc use was 3.941 million tons compared to 3.197 million in the January-April 2009 period, but supply more than made up for this, rising to 4.121 million tons from 3.456 million a year earlier. As far as we can tell, the ILZSG has yet to change its overall supply/demand estimates for 2010, calling for a surplus of 418,000 tons this year, substantially higher than the 227,000-ton forecast last October. Despite the negative backdrop, we expect the market to remain in a trading range over the next several weeks, and do not see a breach of the mid-June lows. On the upside, we could rally to \$1970, but would use any advance as a selling opportunity.



3-MONTH LME LEAD

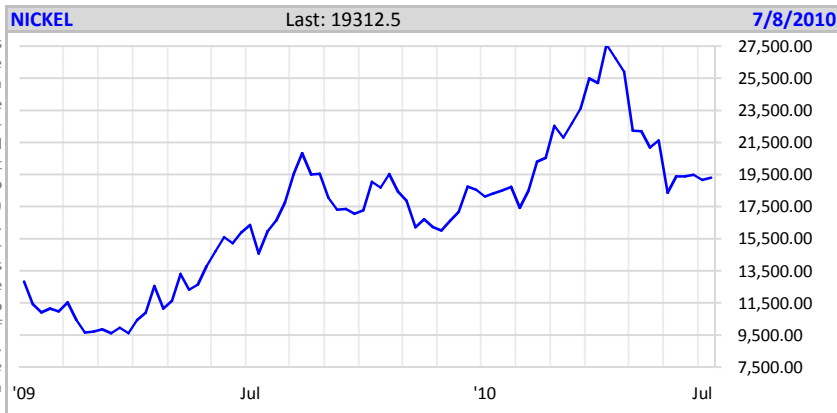
Prices have recovered from their early June low of \$1535, and are now trading at \$1764, but the bounce has not been that convincing and we could languish as these levels for several more weeks. The complex is weighed down by steadily worsening fundamentals, with LME stocks being close to six-year highs. US replacement battery demand is also sluggish, just as new car sales are moderating. In the latter regard, US car sales came in at an annualized 11.1 mln units in June, higher than 9.7 mln seen a year ago, but lower than April's 11.2 mln and May's 11.6 mln. Even in China, sales are slowing, with June sales up 10.9%, down from 25% in May. On the positive side, hot summers typically boost replacement battery demand, and given the early heat wave here on US east coast, demand should be ticking higher. Additionally, the relatively high level of canceled warrants on the LME, (some 8.1% of total stocks, and the second highest percentage in the metals complex), suggests that metal is being prepared for physical departure. Additionally, one key announcement could give prices a boost, and that is whether Doe Run Peru's La Oroya smelter will restart later this month. The government threatened the facility with closure if it does not restart operations by July 24th.



Source for Charts: Bloomberg

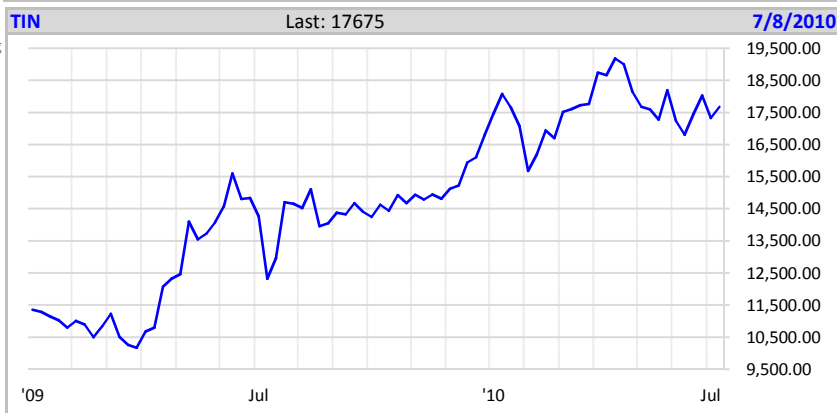
3-MONTH LME NICKEL

Prices hit \$20,500 several times this past month, but the complex was unsuccessful in taking this level out. We have since drifted lower, and are now hovering just above \$19,000. The major news item occurred just in the last week, when Vale announced that it had reached a tentative agreement with its Sudbury and Port Colborne workers, leaving the company's Voisey's Bay operation still on strike. (A settlement is expected here as well). Although there was no noticeable reaction in the market outside of a modest downtick, it remains to be seen how Vale is going to handle a substantial amount of production (possibly up to 140,000 tons) that could potentially hit the market. We suspect they will tread carefully, as nickel is expected to be in a slight deficit this year, although we suspect it will eventually move towards a balance. Not helping matters, is the fact that stainless demand has turned spotty, and is well off the stronger pace seen earlier in the year. With nickel stocks continuing to push lower on the LME, (off by some 40,000 tons since the beginning of the year), we expect prices to hold above their early June low of \$17,375, but this is contingent on whether Vale holds the line on production. If the market picks up on signs that it will not, best evidenced by a turn in stocks, we could easily break back below \$15,000.



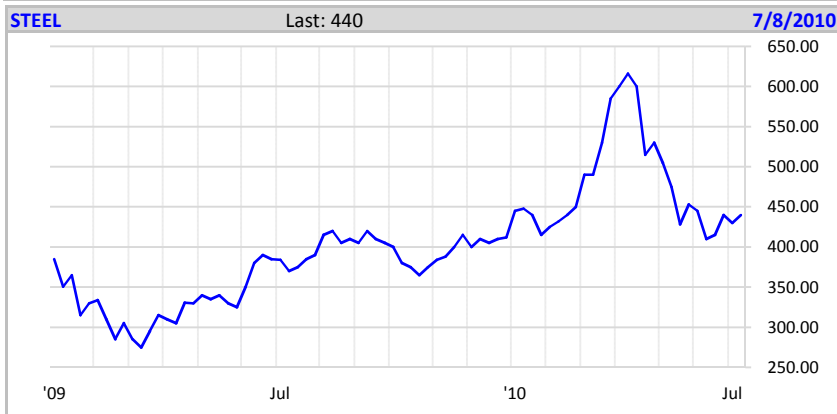
3-MONTH LME TIN

Tin has held up reasonably well, and in fact, has been the best performing metal in the metals group so far this year. This is partly due to the fact that tin is not a market where funds play freely, so its decline was somewhat limited. Moreover, stocks have been dropping steadily for most of the year, now standing at around 17,000 tons, down from the 28,000-ton peak hit this past February. (Of this amount, almost 10% is in the form of canceled warrants, the highest percentage in the base metals group). ITRI, the UK-based tin industry association, is still sticking to a 2010 supply/demand deficit of some 15,000 tons, which is fairly significant for a 340,000-ton market. More importantly, with only a handful of suppliers, of which Indonesia is the primary producer, the market is limited in terms of how quickly it can turn on production. Tin sank to a low of \$15,500 in the early June meltdown, but we think this is the likely bottom for the year, assuming our scenario for slow but steady growth remains intact. On the upside, we do see a spike to the \$19,500-\$20,000 level, perhaps by year-end.



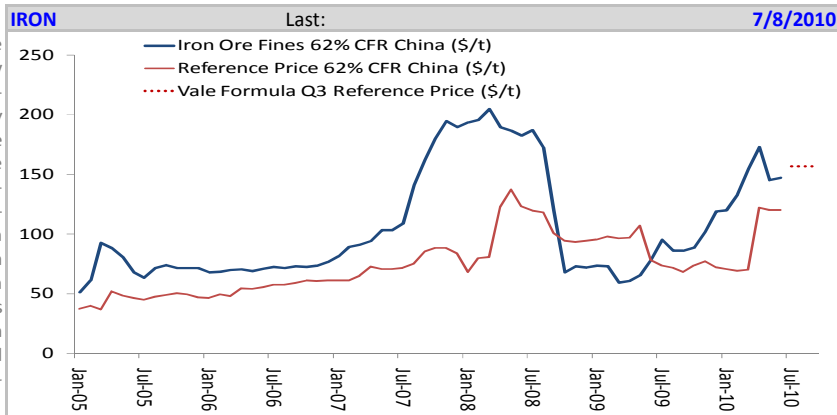
LME STEEL

Steel prices have joined their nonferrous cousins in moving lower over the June and July period. The LME billet contract is down almost 20% in the last month, with Black Sea FOB billet is now offered at \$450-\$470. Domestic US steel prices for hot-rolled coil fell 4.5% in June, and are now trading at \$620-\$630/MT. Even Chinese prices are weak, with hot-rolled prices quoted at \$590/MT, about \$35 a ton less than in the US. Potentially supporting prices, are planned production cutbacks. In this regard, ArcelorMittal said last month that it was considering halting up to three European blast furnaces in Q3, and is also planning cuts at its Indiana facility. Russia's Severstal is expected to idle its blast furnace in Maryland this month, but markets need to see more substantial cutbacks, particularly from the Chinese, who may very well step up their aggressive export efforts prior to the government slashing tax rebates on exports later this month. All this is not taking away from trading activity in the LME futures, where volumes hit a record level in June. The two LME contracts will merge into a single one later this month.



IRON ORE

Iron ore prices have been falling sharply since our last report, off by some 30% since the recent peak of \$180/MT. We are now at a three-month low of around \$139 basis the spot Australian benchmark (with 62% iron content). Last month, there was some concern that the switch to quarterly contracts from the now-defunct annual type of pricing could give the miners more pricing power, but this clearly has not happened, as the drop-off in Chinese demand has overpowered any potential pricing pressures that the new quotation system could arguably generate. In addition, local Chinese supply has ticked higher, further displacing imports. In 2009, China depended on imports for 72% of its iron ore needs, up from 16% in 2009. This past year, reliance on imports has dropped 66%, and in June, import data out in the last week shows month-over-over declines and year-over-over declines of 9% and 15%, respectively. We expect iron ore prices to range between \$100-\$150 over the next two years, but fall to \$60-\$100/MT as new supply comes in after that. *Contribution by Andrew Gardner and Tobias Woerner.*



GOLD NEARBY CONTINUATION

There has been a disconnect in the gold pricing model over the past few months--prices headed higher in April and May despite the stronger dollar, but started to ease over the last six weeks or so, roughly when the dollar topped out. This direct correlation is unusual, and tells us that gold has become more of a "crisis gauge", similar to what the dollar --and the bond markets -- have become. The Chinese also threw some cold water on prospects for an upward spike when the head of China's foreign exchange bureau said gold is unlikely to become a major part of the country's foreign reserve. On the physical side, demand remains sluggish; purchases by India may tumble by as much as 36% this year, and already, imports are down by about half in the last three to four months alone. However, investment demand is holding up, with global holdings of gold by ETFs now at a record 2,069.5 tons as of early July. We still remain bullish on the metal, and see good support on the charts around \$1160, but with markets stabilizing somewhat, we are not in a rush to buy the dips.



SILVER NEARBY CONTINUATION

Silver has retraced from its \$19.60 high reached in May to currently trade around \$17.63 basis the September contract. There is good support around the \$17 level, at which point we would look to do some buying to test the bottom end of the range. Physical sales remain strong, but with the main driver being gold, we suspect things will remain on the quiet side for the time being.



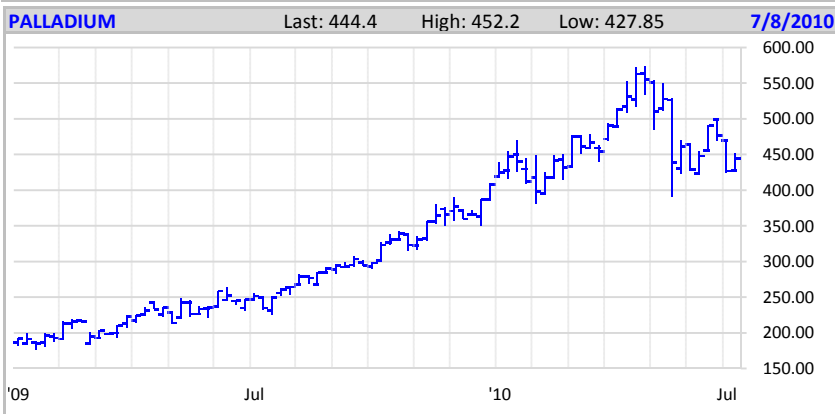
PLATINUM NEARBY CONTINUATION

Platinum spiked by roughly 10% over the first two weeks of June, but gave back all its gains in the latter half of the month. The complex was buffeted both by the precious metals decline, as well as the weaker tone seen in the base metals. In addition, the complex is under pressure on account of softening global car sales. We did make a note of these more sluggish trends in our lead commentary, but it bears repeating here; US car sales came in at annualized 11.1m units in June, higher than 9.7m a year ago, but lower than the 11.2m recorded in April and the 11.6 mln units seen in May. Sales in Germany were 32% lower last month than in June 2009, and French auto sales were down by 1.2% over the same period. China's car sales grew by 10.9% for June, but were down by more than half from the 25% growth seen in May. With this uninspiring backdrop, we see a decline to around \$1400 on the charts, with \$1660 figuring as prominent resistance.



PALLADIUM NEARBY CONTINUATION

Similar to platinum, palladium prices spiked higher over the first two weeks in June, but have since retrenched, and we are now on the verge of breaking key support at \$420. The complex is likely to follow platinum more closely than gold or silver, as it is perceived to be more of an industrial play, this despite an active ETFs tracker behind it. We see prices working a little lower over the summer months, and expect a breach of \$420 support to possibly around \$350.



CORN NEARBY CONTINUATION

Corn traded to a low of \$3.55 in early June, but then surged shortly thereafter on the heels of a USDA revision to inventories to 1.603 billion bushels, down nearly 8% from the prior forecast. The news triggered the complex's largest price move in six weeks, but the push fizzled shortly thereafter as prices hit fresh lows in late June on account of better crop conditions. In this regard, USDA reported that 75% of U.S. fields were in good or excellent condition, up from 70% at the same time a year earlier, and that farmers would plant 89.252 million acres of corn next season, an increase of more than 3% over last year. Corn prices staged another advance in late June hitting two-month peaks, this time on reports of rainy weather in the US Midwest that caused flooding and possible damage to crops. We could see the current advance take us to the \$4.00 mark, as charts look friendly, particularly if we take out \$3.80 basis the nearby contract. Amid such a sharp move higher, it was also interesting to note a forecast from Marubeni that China may give up efforts to be self-sufficient in corn and boost imports a staggering 10-fold by 2015.

WHEAT NEARBY CONTINUATION

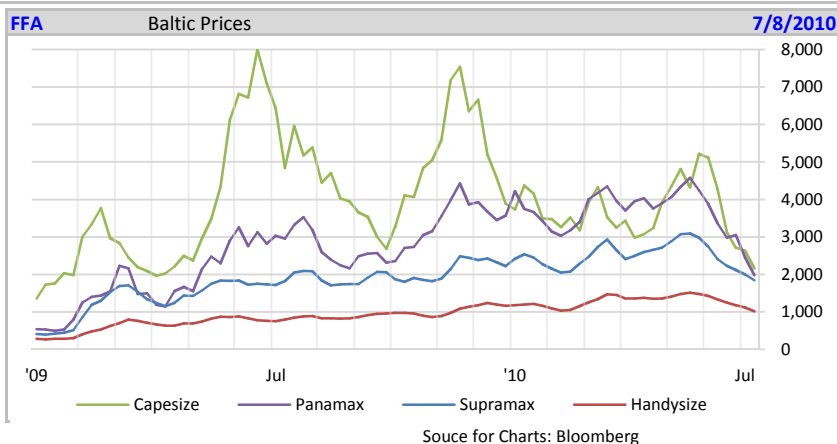
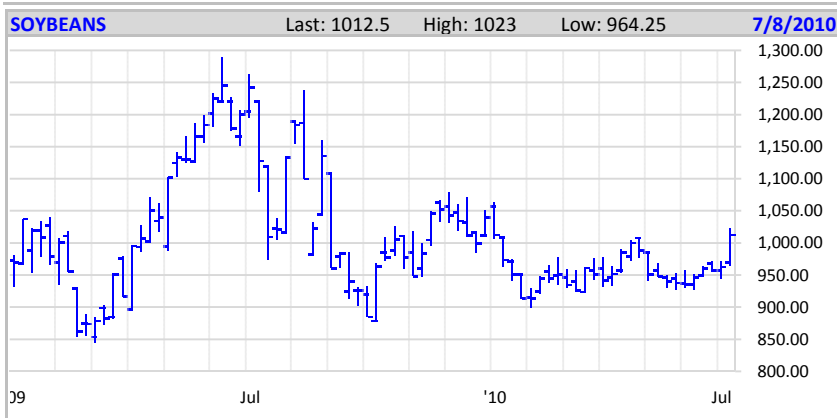
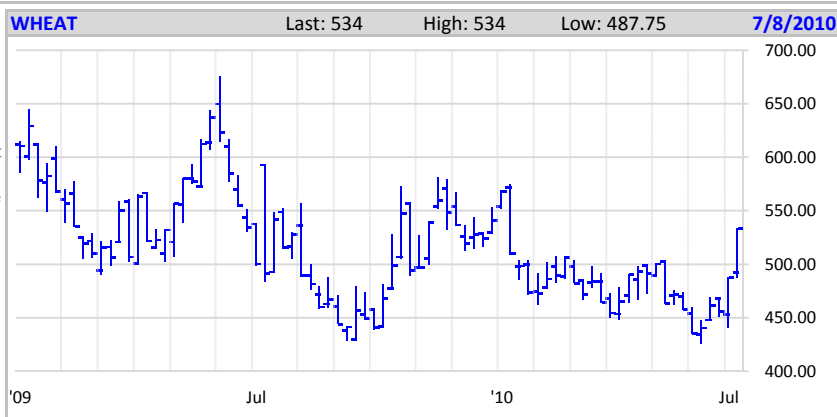
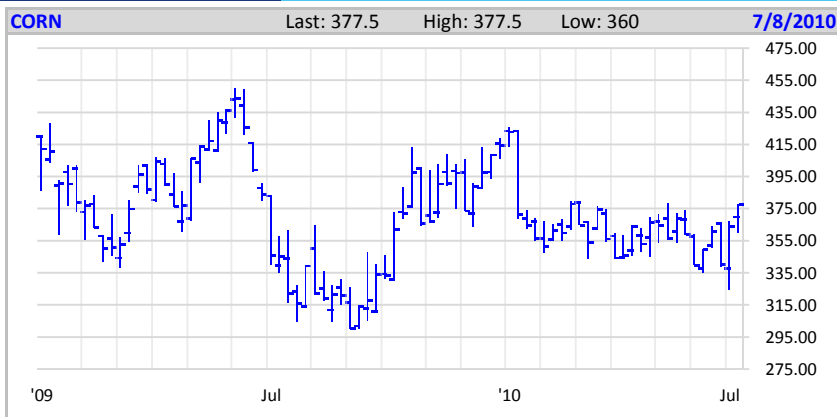
Wheat worked sharply lower in early June due to bearish fundamentals, only to rally in the second half of June. Several items pushed prices higher, including a series of bullish USDA reports, as well as particularly excessive heat in Europe, Russia, Australia, and the UK. (The UK had its driest first half of the year since 1929). Here in the US, it is not so much the heat that is the problem, (apart from the sweltering Northeast), but excessive rain-- more than five times the normal precipitation has fallen on some of the largest wheat regions of the US (and Canada), delaying harvests, and possibly damaging crops. The combination of weather issues on both sides of the Atlantic resulted in prices hitting six-month peaks after their longest winning streak since November. Higher-than-expected production and inventory data out of the USDA on July 9, (with a bumper crop now expected), dampened the rally somewhat, but with weather very much a factor, we are not yet ready to write off the current run just yet.

SOYBEANS NEARBY CONTINUATION

Soybeans had a less volatile trading pattern in June compared to wheat and corn. Prices were struggling early in the month, particularly after the USDA had farmers planting more acreage than forecast earlier, up 1.8% from last year. Production was also forecast to rise by a combined 37% in both Brazil and Argentina. Despite this bearish backdrop, the complex was swept up by the buying that set in over corn and wheat; prices then started to push higher on account of weather concerns and a downward revision of inventories by the USDA. On the weather front, the current worry is that there is too much rain in the US Midwest, while hot and dry conditions in China is also said to be damaging crops, and may explain why soybean imports into China hit a record high this past month. In addition, the market picked up technical steam once key resistance at \$9.70 was taken out basis the July contract. We now are on the verge of another breakout having taken out a breakout point at \$10.10 on the nearby charts, and so have a shot at retesting the December 09 highs. On the downside, we look for support around the \$9.20 level.

FFA

We seem to be in a free fall in the Baltic dry Index, with the index of freight rates on international trade routes falling 2% to 1,902 on Friday of last week, the 31st straight decline. That's the longest losing streak since August of 2001. The FFA curves look a little disjointed at present with the front of the curve showing the collapse in spot rates, while the longer term remains more bullish. Any data supporting the demand case, particularly out of China, shores up the market momentarily, but the pressure still feels downwards. Cape / Panamax ratios are a little on the low side of the historical mean, but only Panamax / Supramax at the front end of the curve demonstrate any real dislocation, trading sub-par out to Q3. *Contribution by Jonathan Hogg from our London office.*



SUGAR CONTINUATION

Last month, we wrote that sugar will likely push to around \$.16 a pound basis the nearby contract, but prices not only did much better than that, but also rose much quicker than we expected. Weather-related issues have been driving the complex higher, with dry weather in Brazil's key growing regions reducing expectations for record output. Dry weather has also been reducing output estimates for Thailand and India, and prices received a further boost in early July after it was reported that Thailand had bought back 100,000 tons to boost domestic supplies. However, some recent price weakness has set in, as a round of profit-taking has set in on expectations that harvests are still expected to come in at close to record levels. With charts no longer looking as friendly as they once were, and fundamentals slightly more accommodative, prices are going to be under some pressure in the weeks ahead, and we expect a drift lower to the \$.1570 support level basis the nearby contact.



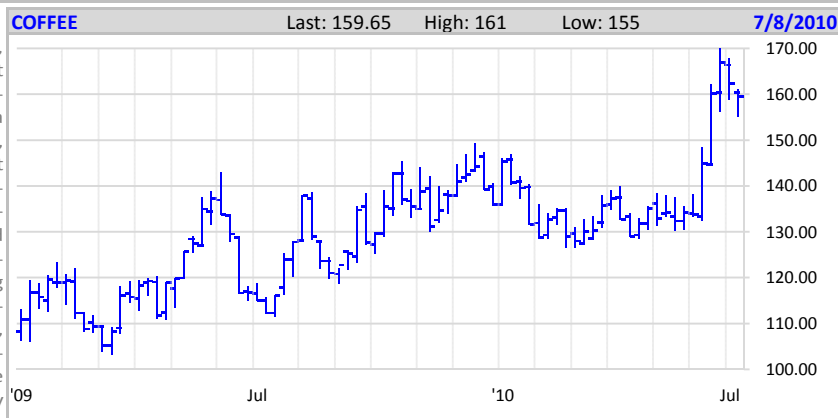
COCOA CONTINUATION

We saw some big price swings for cocoa, particularly on LIFFE, where prices rallied in mid-June to a high of \$3100 basis the July contract on concern over tight supplies, low inventories, and heavy rains in the Ivory Coast and Ghana. Bulls point out that unlike coffee, cocoa is expected to be in a deficit this year, with the International Cocoa Organization raising its deficit forecast through September to 69,000 tons. Despite this shortfall, this year's global cocoa crop will still be only 5% lower than 2006's record crop, and so we think that prices are likely overdone here. Nonetheless, the earlier surge has ruffled some feathers; commercial processors of cocoa-butter and cocoa-powder wrote a letter to the exchange this month claiming that prices were being manipulated. Interestingly, none of the largest cocoa trading companies, prominent hedge funds, or the chocolate companies, signed off on the protest.



COFFEE CONTINUATION

Investment funds pushed coffee to a 12-year high of \$1.765 lb. in June, making coffee one of the best performers in the complex this past month. Inventory drawdowns, low US stockpiles, and production problems in Central America, were all behind the buying. We suspect that a round of short covering was also at work, since at this time last month, prices were caught in a tight trading range, and the ensuing breakout must have wrong-footed some funds. Despite the short-term spike, relatively decent production prospects seem to lie ahead. The USDA is sticking to its forecast that Brazil's coffee crop will increase 23% to a record 55.3 million bags, and also expects world production to rise to 139.7 million bags from 125.7 million. Annual global consumption is forecast to lag output, rising 2.2% to 131.5 million bags, so an overall surplus is expected. We have seen a sharp fall over the last two weeks, and in fact, Robusta had its steepest decline in some eight months in early July. Looking ahead, we expect something of a "reversion to the mean" on the charts to around the \$1.40 mark by the end of August, as the recent rally has done too much, too soon given the looming surplus.



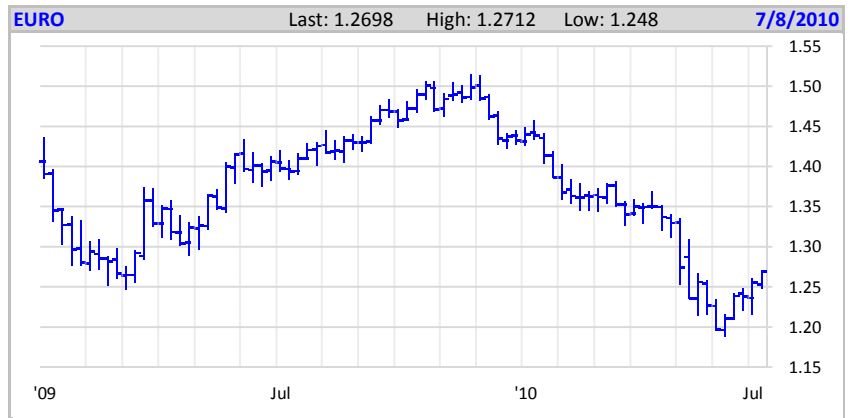
COTTON CONTINUATION

Cotton prices sank to four-month lows in early June in one of their worst selloffs in some 30 years, but then rallied sharply over the balance of the month. The weakness was attributable to reports of record plantings and fears that slowing Chinese and global economies might reduce demand. In addition, a succession of friendlier USDA estimates put the complex under pressure. In this regard, the USDA said that planted acreage would be up 19% from last year, while world production would be up by some 11%. However, markets are still nervous about China; the country has increased its import quota by almost 1 million tons, and plans to sell more from cotton from state stockpiles to meet a local shortfall. Overall, we do see some weakness setting in over the late summer and early fall, as the impact of favorable crop harvests play out. Prices could retest the old lows of \$.76, while on the upside the multi-year resistance levels around the \$.85 level could prove difficult to take out.



EURO

Given the number of funds and investors that were negative on the euro for much of this year, some of the recent rebound in the Euro (from \$1.18 to \$1.27) is undoubtedly attributable to heavy short-covering. But more importantly, the massive stabilization fund that was painstakingly cobbled earlier in the quarter is now in place, and is likely giving shorts some pause. We should note that the Euro crisis has not taken that much of a toll on European growth. While sluggish, the ECB says that growth has actually picked up in the second quarter, no doubt attributable to the weaker euro jumpstarting export activity, particularly out of Germany, where May exports were up over 9%, versus April levels. Nevertheless, although we see the euro potentially strengthening to \$1.30, we would use such a level as a selling opportunity given the still-uncertain fundamentals. One key date to watch is July 23; this is when the results of bank stress tests will be announced. If regulators “cover-up” the magnitude of potential defaults, the currency’s run could very well come to an end.



YEN

The yen has been surprisingly strong of late, now trading at 88.40 against the dollar, and within striking distance of the recent high of 85 reached in late January 2009. We suspect its resiliency is attributable to the recent weakness of the dollar, and also to the fact that the market perceives the yen as a safe haven of sorts given that Japan’s large trade surplus lessens the currency’s dependence on overseas. However, with the export sector being a prime driver for the economy, Prime Minister Naoto Kan will do everything he can to stymie further appreciation, and so we are not that confident about additional gains from here. Also, the defeat of Kan’s centre-left Democratic Party of Japan in upper house elections this week further muddies the waters for the yen, as the result could frustrate Kan’s plans to tackle the country’s huge public debt.



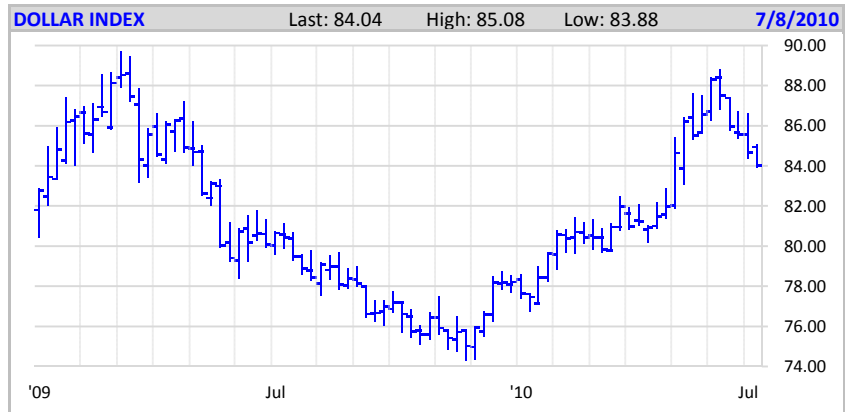
STERLING

Sterling has had a very nice run over the course of June, pushing from \$1.44 to just under \$1.52. Much of the rise has been attributable to an easing of the euro crisis, which in turn, has allowed investors to seek out non-dollar assets. Recently, the Chancellor of the Exchequer has announced \$170 billion of spending cuts and tax increases over the next five years, which he hopes will whittle down the deficit ratio to 5.5% by 2013, from around 11%, and finally get it below the 8% average for OECD countries. By going for such austere austerity measures, Prime Minister Cameron is throwing his lot in with German Chancellor Angela Merkel and ECB head Jean-Claude Trichet. However, the country also risks tipping back into recession, as government spending may not be readily available if needed. We were neutral on sterling in our last report, and continue to remain that way.



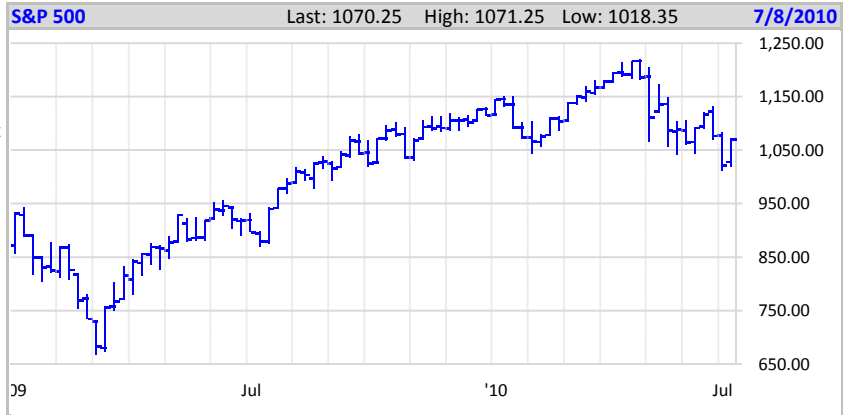
DOLLAR INDEX

Last month, we wrote that the dollar index was approaching double-top and even triple-top territory just under the 90 level, and that indeed proved to be the case. A 67% retracement would bring the index down to the 80 mark, a technical level we would go long at. In addition, the dollar could eventually benefit from an inevitable rise in US interest rates, which we think the Federal Reserve will put through once the job market starts gaining some traction.



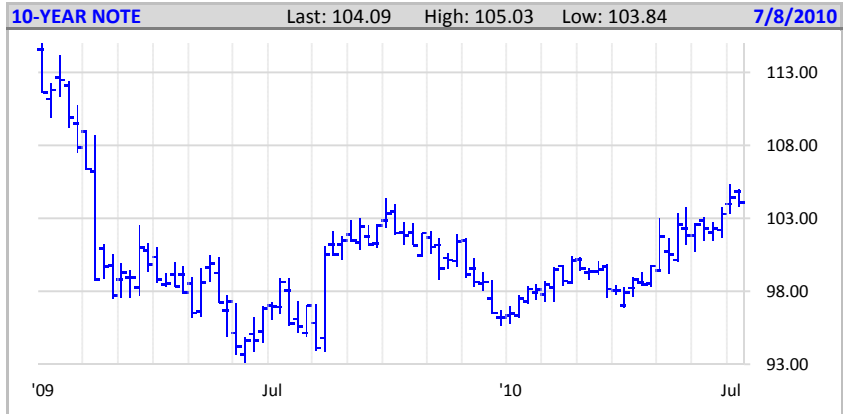
S&P 500

Things looked quite shaky for the S&P 500 in early July, especially after the index broke key nine-month support at 1030 and made its way all the way to 1010 before rebounding strongly as of this writing. We think the market has been thrown a lifeline by second-quarter earnings results that are starting just now. These are expected to be quite strong, (up 27% year-on-year) and should be a welcome distraction from ongoing concerns about sluggish growth and a listless job market. The current rally could extend through August and into the early fall, but the mood might turn uneasy ahead of the upcoming November congressional elections. The best possible outcome here would be if the Republicans make solid gains, thus ensuring continued deadlock and a likely continuation of business as usual for Wall Street.



10-YEAR NOTE

The US 10-year has been another big winner this past month, as investors sought its safety amid the turmoil seen during much of the second quarter. Although the accelerating US recovery and the massive federal deficits should both be nudging rates higher, investors are oblivious to this, snapping up bonds at the faintest sign of crisis. However, with a measure of stability returning to the Euro, and the US stock market doing much better lately, bonds prices have skidded, with last week's decline being the largest since April. Nevertheless, charts still look very solid, any given the macro uncertainties and an accommodative Fed, we see no reason for much price deterioration over the balance of the year and expect the 10-year yields to be stuck around the 3% level.



Source for Charts: Bloomberg

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