

Agricultural commodity price preview

Up, up and away!

Agricultural commodity markets were once again topical in 2010 because of widespread, weather induced, production downgrades. Prices surged, but agricultural commodity demand, particularly in emerging nations, remained resilient. As a result, global stockpiles of many key commodities have been eroded to historically tight levels.

The strength in the agricultural commodity markets is broad based. Nearly all of the ags have a positive story to tell. As with the 2007/08 commodity price spike, global grain supplies have tightened. And as with 2007/08, current oilseed supplies, particularly in the US, are tight. But the current bull market is different to 2007/08, because, this time, more commodities are involved. This time, the *softs* – namely sugar, cotton and coffee – are involved because their stocks are ominously low. Back in 2007/08, the supply of *softs* was comfortable.

Combined global inventories for agricultural commodities (wheat, corn, soybeans, cotton and sugar) are significantly tighter than during 2007/08. The most significant stock tightness current exists in the corn, sugar and cotton complexes.

It is understandable that the CBA Rural Commodity Price Index has recently exceeded its 2007/08 peaks, both in USD and AUD terms. Agricultural commodity price inflation, or “food price inflation” or “agflation”, or whatever term you want to use, is real. And it is of serious concern to policy makers around the world.

High prices are currently needed to achieve two main objectives: (1) Commodity demand needs to be rationed. We believe that these high prices will achieve this goal; and (2) The area planted to most commodities must increase. This is where things get interesting, because all commodities are chasing increased area. The “turf war”, or “battle for acres”, in 2011 is set to be the most intense in history.

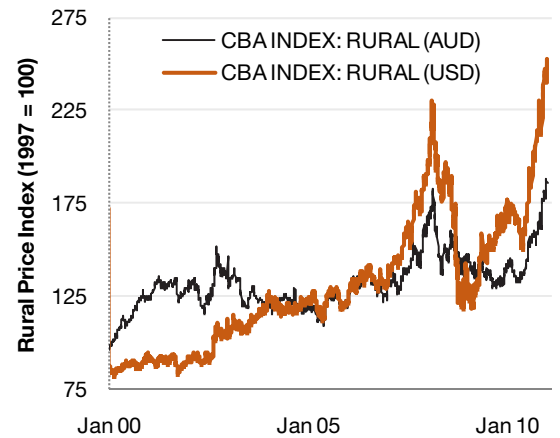
Price outlook

Within this report, we outline our views for global Agricultural commodity prices for the coming years. In particular, we review our grain, oilseed, fibre, sugar and beef price forecasts.

We expect strong agricultural commodity prices to persist over the next two years. And further gains are possible, particularly in the first half of 2011, if the market becomes concerned about area planted, or La Nina related weather issues. Put simply, the world cannot afford a repeat of the 2010 weather related crop losses.

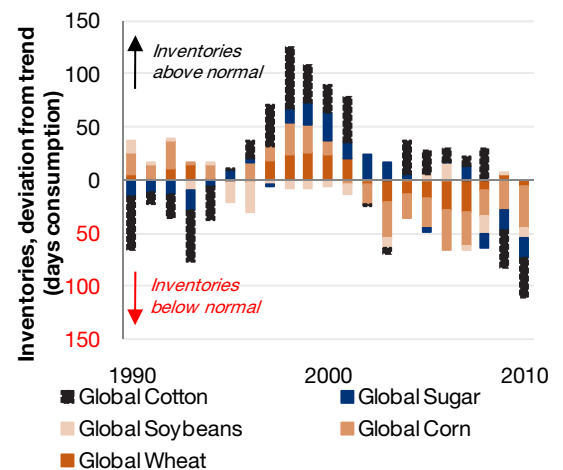
Within the complex, we favour corn. Corn supplies are already extremely tight, and are right in the firing line of the Argentine La Nina. Elsewhere, we are wary that global wheat prices have the potential to rally, if 2011 production disappoints. But, if the world wheat crop surprises to the upside, the bullish news will largely evaporate. Cotton prices, in our view, face the largest downside risk. We expect a rebound in cotton production over the next 12 months.

Figure 1: CBA rural commodity price index



Source: CBA

Figure 2: Global commodity inventories



Source: USDA and CBA

Figure 3: Global ag commodity price forecasts

		2009	2010	2011 (f)	2012 (f)	2013 (f)
CBOT wheat	USc/bu	529	583	809	690	610
ASX NSW wheat	A\$/t	252	247	322	298	279
CBOT corn	USc/bu	376	434	654	552	439
CBOT soybeans	USc/bu	1,044	1,059	1,254	977	963
ICE canola	C\$/t	420	448	590	500	435
ICE cotton	USc/lb	57.7	95.8	117.7	77.5	76.0
ICE sugar	USc/lb	18.7	22.6	25.9	17.0	16.1
Wool (EMI)	A\$/kg	8.0	9.1	11.0	8.8	9.1
Beef (EYCI)	A\$/kg	3.1	3.6	3.7	3.4	3.3

Source: CBA forecasts (calendar year average)



Figure 4: Global agricultural commodity price forecasts – Commonwealth Bank Research

		Current at 20/01/2011	Actual (Quarter Average)				Forecast (Quarter Average)											
			Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
North American Grains & Oilseeds																		
Wheat (CBOT)	US\$/bu	804	477	471	663	721	784	867	833	750	710	702	690	660	630	603	601	605
	US\$/t	295	175	173	243	265	288	318	306	276	261	258	254	243	231	222	221	222
	A\$/t	299	195	199	265	268	284	318	320	297	288	291	295	285	272	261	260	262
Corn (CBOT)	US\$/bu	654	360	360	438	580	701	692	633	592	575	567	542	525	475	425	427	429
	US\$/t	257	142	142	172	228	258	254	233	217	211	208	199	193	175	156	157	158
	A\$/t	261	157	163	187	231	254	254	243	235	233	235	231	227	205	184	184	186
Soybeans (CBOT)	US\$/bu	1414	935	959	1056	1288	1381	1417	1200	1017	975	992	975	967	954	960	966	972
	US\$/t	520	344	352	388	473	507	521	441	374	358	364	358	355	351	353	355	357
	A\$/t	526	382	404	422	478	501	520	461	403	395	411	417	418	412	415	418	420
Canola (ICE)	C\$/t	600	379	395	467	551	597	613	582	570	560	520	470	448	431	434	436	439
	US\$/t	601	362	379	448	544	594	603	567	550	535	495	439	415	399	401	404	407
	A\$/t	609	403	435	488	550	586	603	592	593	590	558	511	488	469	472	475	478
Australian Grains																		
Wheat, NSW (ASX)	A\$/t	326	208	202	286	292	329	330	323	307	291	297	305	297	287	276	275	277
	US\$/t	322	187	176	263	289	333	330	309	284	264	264	262	252	244	234	234	235
Feed Barley (ASX)	A\$/t	215	143	153	243	202	225	233	233	223	221	237	255	250	247	236	235	237
	US\$/t	212	129	133	223	200	228	233	223	207	200	211	219	213	210	200	200	201
Sorghum (ASX)	A\$/t	240	196	190	236	235	225	223	223	213	211	227	245	240	237	226	225	227
	US\$/t	237	176	165	217	232	228	223	214	198	191	202	211	204	202	192	191	193
Softs																		
Raw Sugar (ICE)	US\$/lb	31.3	23.5	15.8	21.5	29.6	29.5	25.8	25.8	22.3	18.0	18.0	16.0	16.0	16.1	16.2	16.0	16.1
	US\$/t	690	519	347	475	652	650	570	570	492	397	397	353	353	354	356	353	356
	A\$/t	699	578	400	515	660	641	570	595	531	438	448	410	415	417	419	416	418
Cotton (ICE)	US\$/lb	152.9	77.4	81.8	91.9	132.1	140.0	121.7	110.0	99.2	85.0	75.0	75.0	75.0	75.3	75.8	76.3	76.7
	US\$/bale*	765	387	409	459	661	700	608	550	496	425	375	375	375	377	379	381	384
	A\$/bale*	775	430	470	499	668	691	608	575	535	469	423	436	441	443	446	449	451
Wool, Aust (EMI)	A\$/kg	11.91	9.13	8.85	8.74	9.76	11.81	11.33	10.83	10.00	9.17	8.58	8.50	8.83	9.04	9.09	9.15	9.21
	US\$/kg	11.76	8.22	7.72	8.04	9.66	11.97	11.34	10.37	9.27	8.31	7.61	7.31	7.51	7.68	7.73	7.78	7.83
Livestock																		
Cattle, Aust (EYCI)	A\$/kg	4.06	3.36	3.45	3.66	3.76	3.85	3.75	3.58	3.50	3.50	3.50	3.40	3.30	3.31	3.33	3.36	3.38
	US\$/kg	4.01	3.03	3.01	3.37	3.72	3.90	3.75	3.43	3.24	3.17	3.10	2.92	2.81	2.82	2.83	2.85	2.87
Currencies (period end)																		
AUD/USD		0.99	0.92	0.85	0.97	1.02	1.02	0.99	0.94	0.92	0.90	0.88	0.85	0.85	0.85	0.85	0.85	0.85
AUD/CAD		1.00	0.93	0.90	0.99	1.02	1.03	1.01	0.97	0.96	0.95	0.92	0.92	0.92	0.92	0.92	0.92	0.92

Note: Cotton bales refer to Australian bales (500lb or 227kg)

Source: CBA Research

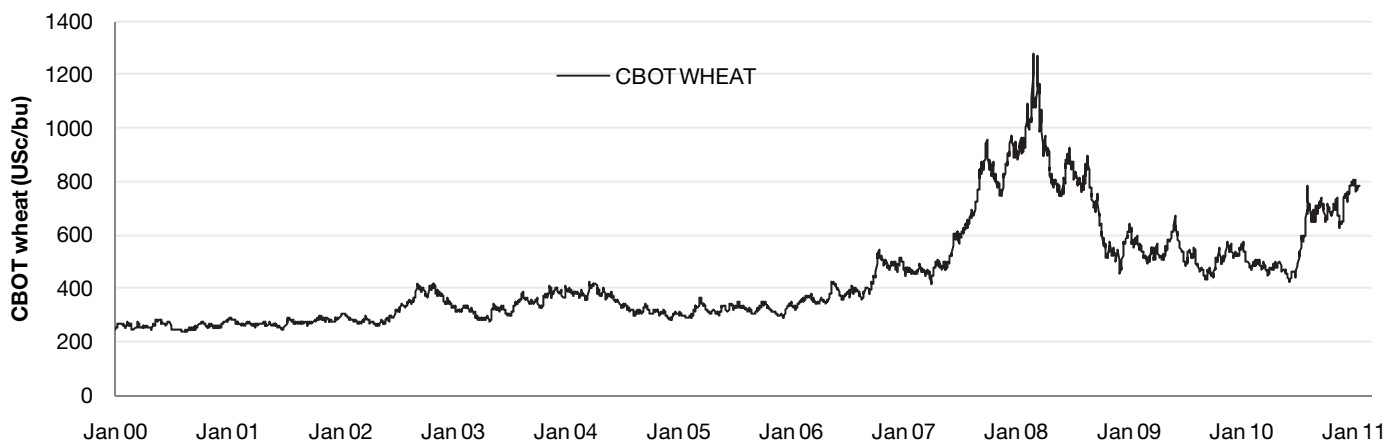


Global grains outlook

Wheat

The global indicator price for wheat (Chicago Board of Trade, first contract) is currently quoted around US\$800/bu, up ~90% from its mid-2010 lows and up 60% from its past decade average. Despite current price strength, the market remains well off the 2008 peak of US\$1334/bu.

Figure 5: World wheat prices (Chicago wheat, first futures contract)



Source: Bloomberg and CBA

But the current global wheat supply is not critically tight, and does not explain the current high prices. At 178 million tonnes, or 27% stock-to-use, the 2010/11 world wheat ending stock estimate easily exceeds the 2006/07 stock-to-use ratio of 20% and the 2007/08 ending stock position of 125mt. Analysis of the current wheat inventory position in isolation overlooks three critical factors:

- A higher than normal proportion of the current wheat supply is only suitable for stockfeed because of quality downgrades.
- The current supply of milling wheat in exporting countries, including Australia, Russia and Canada, is lower than normal because of unfavourable weather. The US has been forced to become the world's supplier of last resort.
- Production prospects for the upcoming 2011/12 season are uncertain because of poor early season conditions in several key regions; including the US, China and the Middle East.

Global 2011/12 wheat supply and demand outlook

We expect wheat consumption to lift by 1.7% in 2011/12 to a record 674 million tonnes, driven by a large 6% lift in stockfeed use to 131 million tonnes, and a more subdued 0.7% lift in human food use to 542.4 million tonnes. The surge in feed wheat consumption is driven by increased feed wheat availability, because of quality downgrades in Australia and Canada, and a relative shortage in world corn and barley supplies. Given current price strength, demand rationing is a risk to these consumption estimates.

Global wheat production prospects for the upcoming 2011/12 season are precariously positioned because of weather concerns.

Despite strong prices, global wheat area is unlikely to lift significantly next season. Dryness during the northern hemisphere autumn planting period – the Russian wheat planted area reportedly fell 20-30% short of intentions because of lingering dryness – and strong competition from other



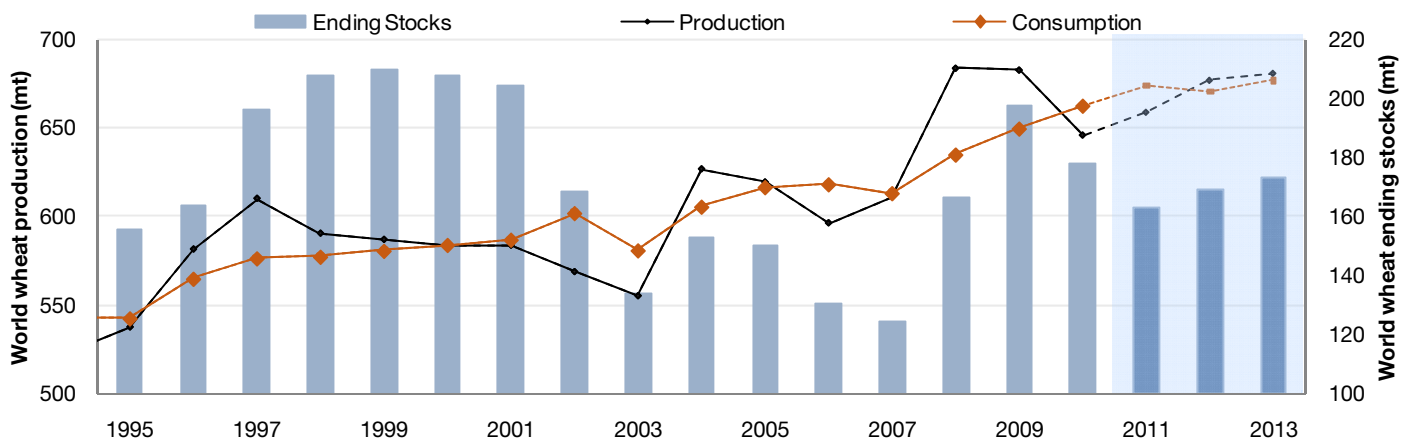
agricultural commodities, are the main constraints to the increased 2011/12 wheat area.¹

And yield prospects for many northern hemisphere winter wheat crops, including the US HRW and the Chinese winter wheat crop, are below average because of unfavourable early season weather. While there are concerns for some Middle East wheat yields, we expect Russian and Black Sea yields to increase from the drought ravaged result last year. Globally, we expect yields to be flat year-on-year, resulting in a crop of 659 million tonnes.

As a result, we calculate the world wheat market will face a 15 million tonne wheat production deficit in 2011/12, following the 17 million tonne deficit of 2010/11. Under this scenario, global wheat stocks will be drawn down to 163 million tonnes, and the inventory rebuild that occurred between 2007/08 and 2009/10 will have been partially eroded. The 2011/12 stock-to-use ratio may decline to around 24%, from 27% in 2010/11 and 30% in 2009/10. But, this still exceeds the 2007/08 result.

Importantly, we believe world wheat stocks are likely to begin rebuilding again from the following season, thereby averting a serious 'food security' scare.

Figure 6: World wheat consumption, production and ending stock estimates.



Source: USDA and CBA

Wheat price outlook

An expected tightening in global wheat supplies in 2011/12 underpins our forecast for stronger wheat prices over the coming 6 - 12 months. While tight corn supplies, and associated price strength, should continue to support the wheat market.

But, further gains in world wheat prices may become more difficult to achieve, because current pricing already appears to account for a tightening in global availability, plus the need for a supply response. It is expected that high prices will induce an area response in 2012/13, underpinning a rebound in global wheat production and a stock rebuild. As the rebuild in global stocks nears realisation, we expect a softening in world wheat prices.

The main downside risks to higher prices are a larger than expected northern hemisphere spring wheat planting program, or a steep reduction in livestock feed demand, because of price strength. The main upside price risks stem from poor yields in the US, the Middle East, the Black Sea Region or China.

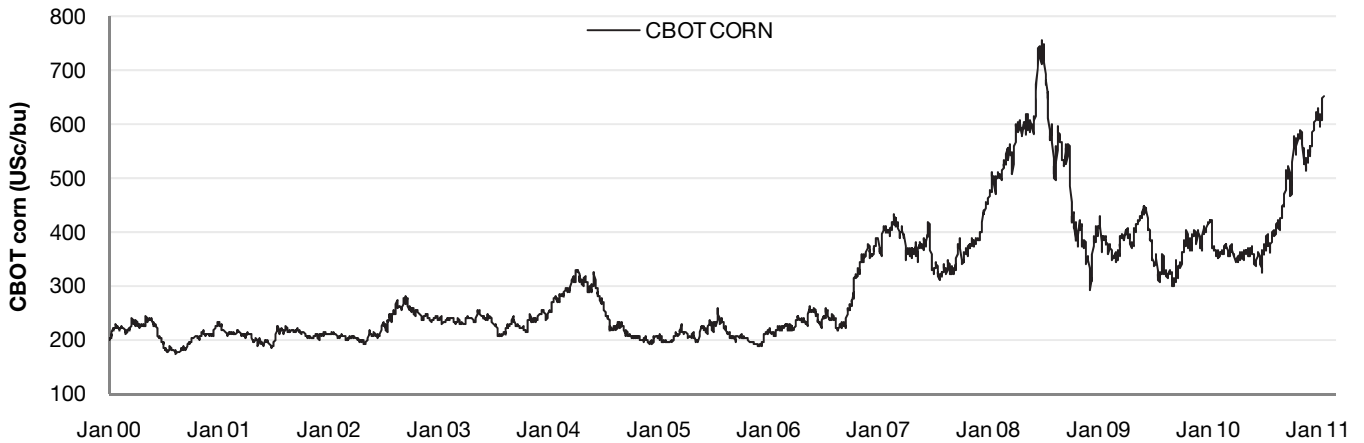
¹ We calculate the global wheat planted area to lift by 2% to 226.7 million hectares in 2011/12. The acreage response is presumed to be more muted than observed in 2007/08 and 2008/09 (2.2% and 3.4% respectively).



Corn and coarse grains

US corn prices, at USc650/bu (basis Chicago, first contract), are nearly 100% above their mid 2010 lows, and are within striking distance of the 2008 record price of USc765/bu.

Figure 7: World coarse grain prices (Chicago corn, first futures contract)



Source: Bloomberg and CBA

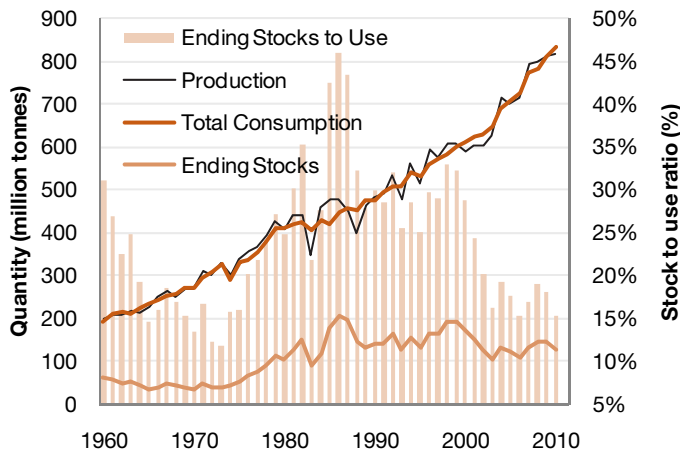
Current price strength exists despite two consecutive, record large, global corn crops. Yet these record crops proved inadequate to satisfy voracious global coarse grain demand, which has grown by 3-4% per annum over the past two seasons, largely because of the booming ethanol market.

Because of booming demand, global corn inventories in 2010/11 are forecast to fall to a four year low of 127 million tonnes. The stock-to-use ratio is forecast to be only 15.2%, equal to the 2006/07 record low. Corn supplies in the US are forecast to collapse to 19 million tonnes (5.5% stock-to-use), compared to 33 million tonnes (11.6% stock-to-use) in 2006/07.

Compounding the tight corn supply situation is a limited world barley supply, brought on by crop disappointments in Canada, Russia-Black Sea and Europe. The global barley stock-to-use ratio for 2010/11 is forecast at 16%, only marginally above the historic lows of ~15% observed in the 2006/07 and 2007/08 seasons. Substitution from corn to barley use is limited this season.

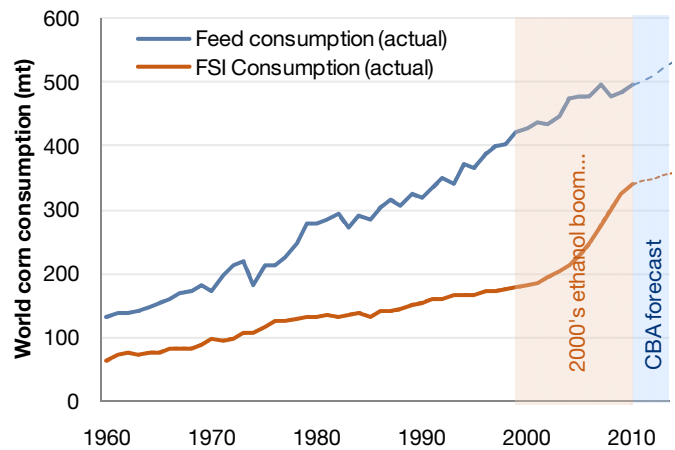
Another, substantial, positive influence on prices is Argentina's La Nina induced dryness; the world's second largest corn exporter. The USDA has forecast Argentina's corn crop at a record 23½ million tonnes, based on yields of 7.3t/ha. But, many suggest this forecast is too optimistic. Argentina's current moisture deficiency is reported to be comparable to 2008, when yields were only 6.2t/ha. And in the 2007/08 La Nina, yields were 6.5t/ha. We estimate that Argentine corn production may come in at under 22 million tonnes, 1.5 million tonnes below the USDA's forecast.

Figure 8: World corn production, use and stocks



Source: USDA and CBA

Figure 9: World corn consumption by type



Source: USDA and CBA



Coarse grain price outlook

Current tight coarse grain supplies, particularly in the US, plus probable Argentine production downgrades means corn prices will remain strong. In 2011/12, global coarse grain inventories must lift. An increase in world acreage will be the primary mechanism by which this will happen. But with prices of competing crops (such as soybeans, cotton and wheat) extremely strong, corn prices cannot afford to relax before the northern hemisphere autumn planting season.

Following the planting season – and assuming area increases and conditions are favourable – corn prices should moderate. But, it is unlikely that there will be a substantial decline in price, because the required grain inventory rebuilding effort will take more than one season.

The main upside risk to global corn prices is a failure of the South American crop. A repeat of the 2007/08 Argentine crop failure could result in record high global corn prices. The primary downside risks for global coarse grain prices is a contraction in livestock feed use because of a contraction in the global livestock sector, a greater than expected substitution of corn for feed wheat in livestock rations, or a deterioration in the global economic environment. The fact that corn prices are already exceptionally high is perhaps its biggest constraint to further appreciation.

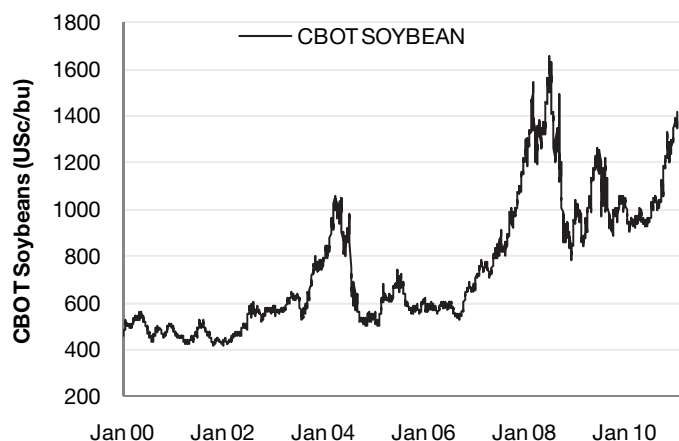
Figure 10: Global grain price forecasts

		Current	Forecast (Quarter Average)											
		at 20/01/2011	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
North American Grains														
Wheat (CBOT)	USc/bu	804	784	867	833	750	710	702	690	660	630	603	601	605
	US\$/t	295	288	318	306	276	261	258	254	243	231	222	221	222
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Feed Barley (ASX)	A\$/t	215	225	233	233	223	221	237	255	250	247	236	235	237

Global oilseed outlook

The global indicator price for oilseeds (Soybeans - Chicago Board of Trade, first contract) is currently quoted around USc1420/bu, up some 40% since late December 2009 (USc1000/bu) and up 80% from the recent decade average. Current prices are only 14% below the 2008 peaks.

Figure 11: Soybean prices (Chicago, first futures contract)



Source: Bloomberg and CBA

Figure 12: Canola prices (Winnipeg, first futures contract)



Source: Bloomberg and CBA



A focus on the global soybean inventory position in isolation does not explain the current strength in the soybean market. For example, the USDA forecast global soybean inventories for 2010/11 at a relatively comfortable 58.3 million tonnes, clearly above 2008/09 stocks of 44 million tonnes. The global soybean stock-to-use ratio, at nearly 23%, exceeds the 2008/09 result of <20%.

Instead, the strength in the soybean market is largely explained by the breakneck speed of global soybean consumption, driven by China, and production concerns in South America.

Global soybean consumption has surged by 4.3% per annum since 1990/91, including 7.9% growth in 2009/10 and forecast 7.1% growth in 2010/11. The insatiable global demand growth is due, unequivocally, to China. For instance:

- Since 2004/05, China’s soybean consumption has surged by 28.6 million tonnes (or 71%) to 68.9 million tonnes.
- China has accounted for a staggering 56% of global demand growth since 2004/05.
- Until the mid 1990’s, China was self sufficient in soybeans. Now, at 57 million tonnes, they are the world’s largest soybean importer, with nearly 60% market share.
- In the past 5 years, Chinese import demand growth has surged 15% per annum.
- This year, over 80% of China’s total soybean demand will be satisfied by imported supplies.

This insatiable Chinese demand has eroded US soybean inventories to record low levels. This is despite consecutive record large US soybean crops in 2009/10 and 2010/11. Put simply, over the past few seasons, the Chinese have imported just about every soybean the US has grown. The USDA forecast the US soybean stock-to-use ratio at 4.2%, a 55 year low.

Also supportive for oilseed prices is the La Nina weather risk confronting South American soybean crops. Brazil and Argentina are the world’s second and third largest soybean exporters. Argentine yields, in particular, face downside risks.

Dryness has already forced the USDA to trim their 2010/11 Argentine soybean crop estimate from 52 million tonnes to 50.5 million tonnes. But some analysts expect more downgrades. Oil World pegs the crop at ~50 million tonnes, and has outlined the crop could fall to 46 million tonnes if timely rains are not received. The Rosario Grain Exchange has the Argentine crop at 49.5 million tonnes, while Reuters reported that the crop could be as low as 45 million tonnes. If the Argentine crop comes in below the USDA’s existing forecast, import demand will need to switch to other origins. But this year, US stockpiles appear unable to accommodate significant additional demand.

Supply tightness is not limited to US soybeans

Contributing to the price strength across the oilseed complex is the global supply tightness for other key oilseeds. For example, the global canola stock-to-use ratio is forecast to decline to its tightest level in three years because of an assumed 2 million tonne production deficit. Total vegetable oil stocks for 2010/11 are forecast to be a record low 7%. And the global vegetable meal stock-to-use ratio is forecast at 2.9%, only slightly above the 2008/09 record low of 2.7%.

Figure 13: Global soybean profile

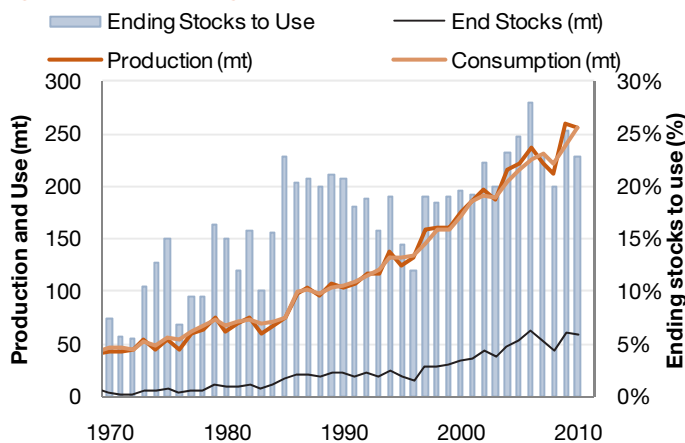
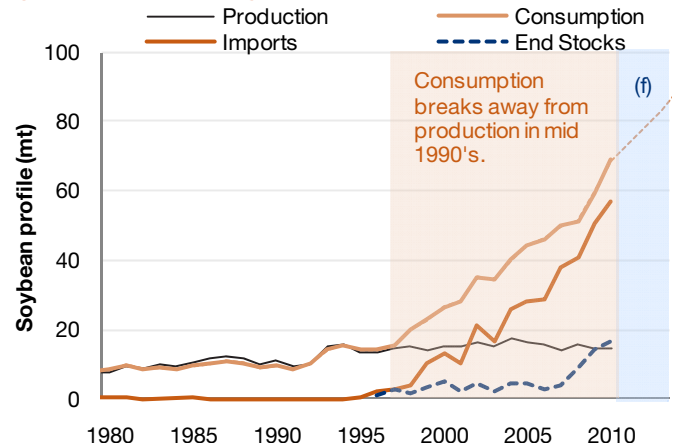


Figure 14: Chinese soybean profile





Oilseed price outlook

Strong Chinese demand, tight US soybean inventories, tightness in canola supplies, and uncertain South American production prospects suggest continuing upward price pressure within the global oilseed market. Oilseed prices will continue to retain an upward bias in order to attract area planted. But this is easier said than done considering the similar situation observed in other agricultural commodities.

The main upside risk to our price forecast centres on production downgrades in South America, and forecasts for possible summer dryness in the US next season because of La Nina. Also, 2011 EU rapeseed crop prospects are uncertain because of late plantings, particularly in Germany.

There are a few potential downside risks to our price forecasts.

- Firstly, global demand may disappoint expectations because of the current strength in prices. This would not be without precedent. For example, in 2008/09 global oilseed consumption contracted by 2% in response to higher prices and the onset of the GFC. Consumption growth for meals and oils slowed. Indeed, OilWorld (7th Jan) noted that “*at current very high levels there is an increasing likelihood of [rapeseed oil] demand losses in the energy sector, which absorbed approximately two thirds of total EU rape oil consumption in calendar year 2010.*”
- Secondly, growth in Chinese oilseed demand may slow because of government policies aimed at controlling Chinese food price inflation. Because of their importance, any slowdown in Chinese soybean demand would be felt sharply in the global market.
- Thirdly, Chinese oilseed inventories are exceptionally large (Figure x). At more than 16.5 million tonnes, Chinese soybean stockpiles are at record levels, and compare to Chinese stocks in 2006/07 of only 2.7 million tonnes. The Chinese soybean stock-to-use ratio is a whopping 24%. There is a significant risk that the Chinese will begin to draw down these stockpiles if global markets become too hot.² If this practice was to occur extensively, demand for US and South American beans would fall sharply, thereby placing downward pressure on prices.

Figure 15: Global oilseed price forecasts

		Current	Forecast (Quarter Average)											
		at 20/01/2011	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
Soybeans (CBOT)	US\$/bu	1414	1381	1417	1200	1017	975	992	975	967	954	960	966	972
	US\$/t	520	507	521	441	374	358	364	358	355	351	353	355	357
	A\$/t	526	501	520	461	403	395	411	417	418	412	415	418	420
Canola (ICE)	C\$/t	600	597	613	582	570	560	520	470	448	431	434	436	439
	US\$/t	601	594	603	567	550	535	495	439	415	399	401	404	407
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Global fibre market outlook

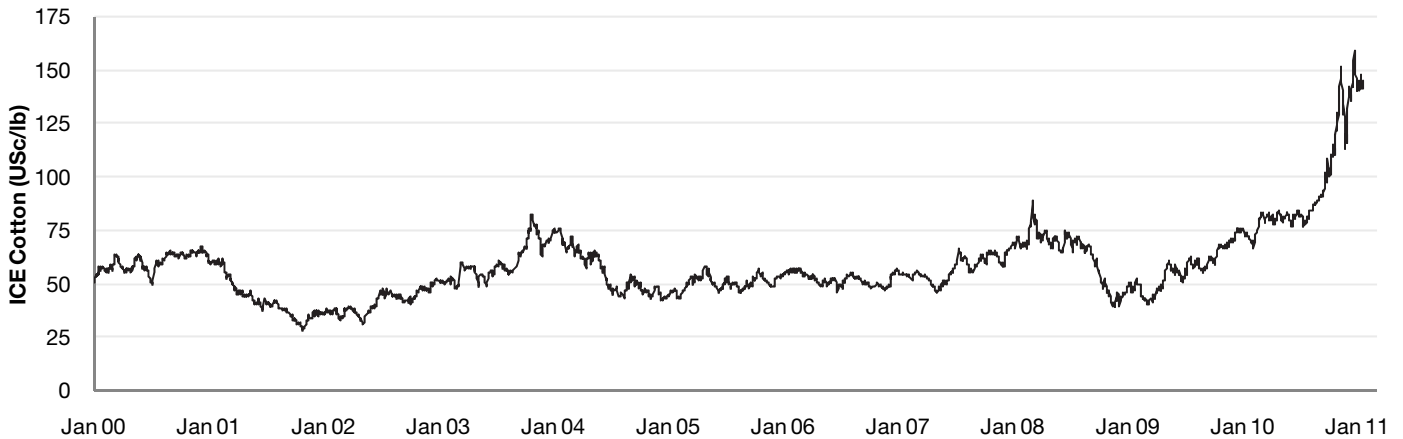
Cotton

At over US\$150/lb, US cotton futures are more than 2.70 times higher than their decade average of US\$55/lb and more than double the values of a year ago. The previous modern day price record, set back in 1995, was way back at US\$117.20/lb.

² Indeed, on the 18th Jan newswires reported that Chinese authorities released 350 thousand tonnes of soybeans from strategic reserves.



Figure 16: Cotton prices (ICE cotton, first futures contract)



Source: Bloomberg and CBA

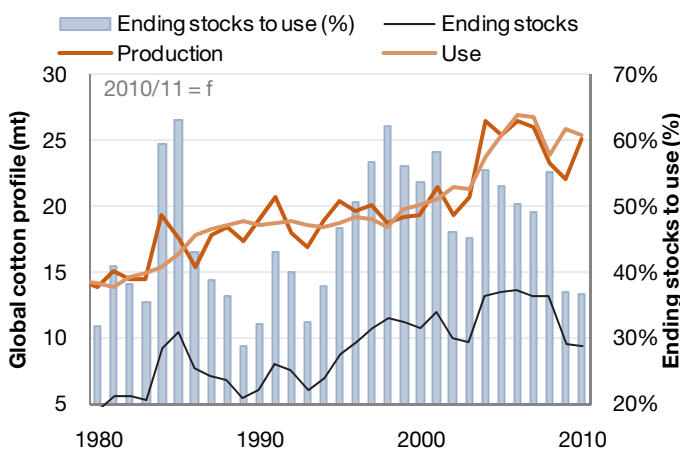
The current strength in cotton markets is because global stocks are incredibly tight for the second consecutive season, despite a forecast 14% (3 million tonnes) year-on-year increase in global cotton production. Ending stocks this season are forecast at only 9.3 million tonnes (~42.8 million bales), the tightest level since 1995/96 season. The global cotton stock-to-use ratio is forecast less than 37% this season, the tightest level since 1993/94.

Such tight stocks, despite the surge in production, is remarkable, and largely because of resilient raw cotton demand. This resilience in raw cotton demand is despite excessively high prices and a still fragile global economy.

The resilience in raw cotton demand has been most evident in the world's key milling country, China, which consumes 40% of the world's cotton and accounts for 40% of global import demand, increased their raw cotton imports by 38% in 2010/11. The surge in Chinese imports was largely met by US supplies. And because of the higher than normal export demand, US cotton inventories are forecast to collapse to only 1.9 million bales (less than 1/2 million tonnes) in 2010/11, the tightest result since USDA records begun in 1960.

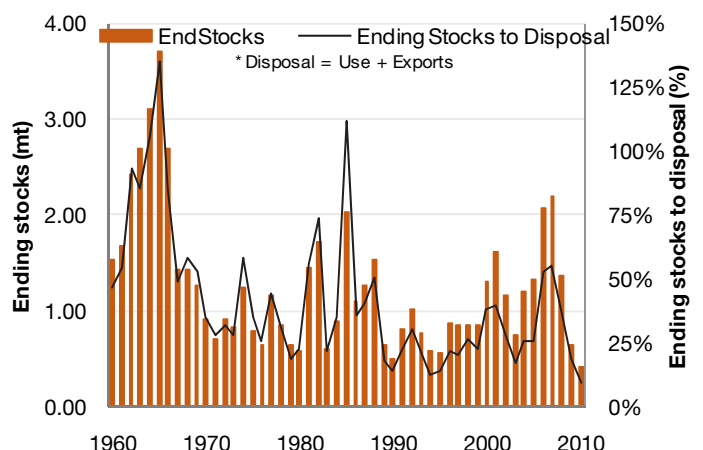
But it is important to ask whether this resilient raw cotton demand has extended to processed cotton yarn and apparel goods. This remains the more difficult question to answer, but anecdotal reports suggest retail apparel demand remains subdued. Price discounting at the retail level remains common, which combined with surging raw cotton prices, implies substantial margin pressure along the supply chain.

Figure 17: Global cotton supply, demand and inventories



Source: USDA and CBA

Figure 18: US cotton inventories



Source: USDA and CBA



Cotton price outlook

Extremely tight supplies, particularly in the US, means global cotton production needs to increase in the coming few seasons. And because of the current supply shortages, prices need to rise to a high enough level to constrain demand. We believe that current global cotton prices are currently at levels which will achieve both objectives.

At current prices, we believe cotton demand in 2011/12 will be flat to slightly lower on a year-on-year basis, while cotton area planted could increase by 10%. This situation would result in a 25% rebuild in global cotton inventories to 11.9 million tonnes (54.6m bales), implying a global stock-to-use ratio in 2011/12 of 47%. This is significantly more comfortable than the 2010/11 ratio of 37%.

This expected inventory rebuild should place substantial downward pressure on global cotton prices over the coming two seasons. The primary upside risk to prices remains weather related production losses or continued resilient demand. The downside risks primarily focus technical selling and profit taking (prices can fall nearly 20% and will still be above the post-Civil War peak), a downturn in the global economic environment or a larger than expected increase in global plantings in 2011/12. We believe there are more downside, rather than upside risks, to our price forecasts.

Wool

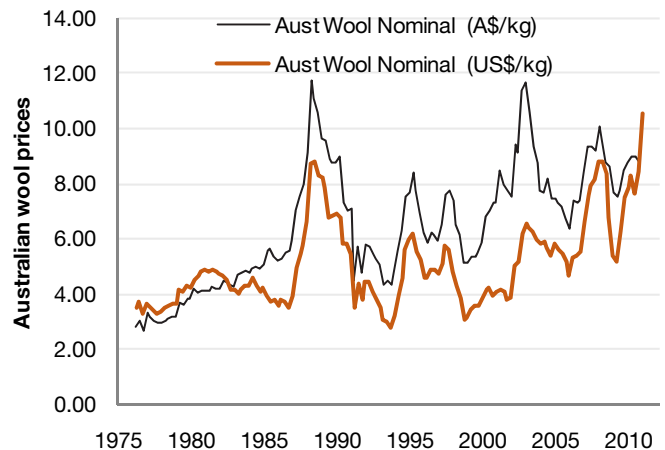
Australian wool prices surged 41% over year to a modern peak of A\$12.42/kg, despite a record strong AUD/USD. Since the Eastern Market Indicator was created in 1998, the previous record high was A\$11.89/kg, reached in January 2003.

Figure 19: Wool prices (Aust Eastern Market Indicator)



Source: Bloomberg and CBA

Figure 20: Long run wool prices (A\$1256kg april 1998)



Note: AWI Index used pre Q3 1995. AWI EMI used post Q3 1995.

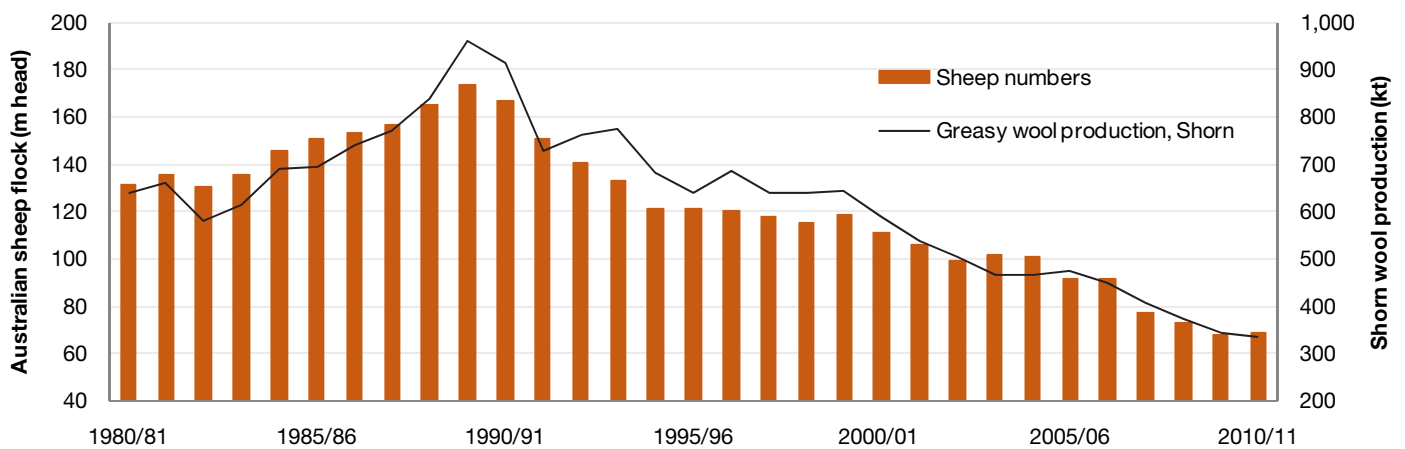
The strength in wool prices is being influenced by two primary factors. Firstly, the price of cotton (the primary natural fibre substitute) is at record high levels owing to supply limitations. Secondly, Australian wool supply continues to decline despite favourable seasonal conditions.

The decline in wool supply is due, in part, to the continued focus on sheep meat production. This has two main consequences. Firstly, the composition of the flock continues to shift toward meat breeds rather than Merino, reducing the supply of quality Merino wool. Secondly, the turnoff of animals continues at a younger age, reducing wool yield per animal.

The latest ABARE statistics on sheep numbers and wool supply support these trends. ABARE have forecast the Australian sheep flock will *expand* by 0.5% to 68.4 million head in 2010/11, but the number of sheep shorn will *fall* by 5% to 76 million. As a result, shorn wool production is forecast to decline to 335 thousand tonnes (greasy equivalent) in 2010/11 from 341 thousand tonnes in 2009/10. In 1989/90, Australian greasy wool production reached a record 960 thousand tonnes.



Figure 21: Australian sheep flock and wool production



Source: ABARE and CBA

Wool price outlook

Despite strong wool prices, comparable strength in sheep meat prices suggests the Australian sheep flock will continue to shift away from Merinos to dual purpose breeds. So despite improved seasonal conditions, Australian wool production and exports are unlikely to recover, at least substantially, over the next few seasons.

This expectation of continued tightness in wool supply, combined with our elevated cotton price forecast, underlies our forecast for continuing strength in Australian wool prices. Because of the current elevation in wool prices, we believe additional upside price potential is constrained. The main upside risk to price is a deterioration in the value of AUD, occurring together with strong global fibre markets. The main downside risks to prices include a sharp deterioration in the global economic environment, a sharp deterioration in global cotton prices, or an increased substitution away from wool to synthetic yarns.

Figure 22: Fibre price outlook

		Current	Forecast (Quarter Average)											
		at 20/01/2011	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
Cotton (ICE)	US\$/lb	152.9	140.0	121.7	110.0	99.2	85.0	75.0	75.0	75.0	75.3	75.8	76.3	76.7
	US\$/bal	765	700	608	550	496	425	375	375	375	377	379	381	384
	A\$/bale'	775	691	608	575	535	469	423	436	441	443	446	449	451
Wool, Aust (EMI)	A\$/kg	11.91	11.81	11.33	10.83	10.00	9.17	8.58	8.50	8.83	9.04	9.09	9.15	9.21
	US\$/kg	11.76	11.97	11.34	10.37	9.27	8.31	7.61	7.31	7.51	7.68	7.73	7.78	7.83

Note: Cotton bales refer to Australian bales (500lb or 227kg)



Global sugar market outlook

Global sugar prices are unquestionably high. At around US\$31.00/lb, US raw sugar futures are only a few cents away from the US\$34.77/lb, 30 year peak, set in December 2010. And prior to that, the only times when sugar prices have exceeded current levels was in 1980 (US\$45.75/lb) and 1974 (US\$66.00/lb). Back in May 2010, only 8 months ago, raw sugar prices dropped to US\$13.00/lb.

Figure 23: Sugar prices (ICE raw sugar, first futures contract)



Source: Bloomberg and CBA

The global sugar supply situation for 2010/11 is forecast to remain worryingly tight for the third consecutive season, despite a small production surplus. Indeed, the USDA has estimated that the global sugar stock-to-use ratio in 2010/11 will come in at a record low 16.6%, down from 16.9% last year and the 26.5% average observed from 1998/99 to 2007/08.

The primary factor contributing to the steep slide in world sugar inventories from 2008/09 – that is, consecutive failed Indian monsoons – has been well documented. But the market's (and our) expectation for a big production surplus in the current 2010/11 season did not come to fruition. Unfavourable weather in many key regions over the past 12 months has hampered the production response. For example:

- Brazil's centre-south cane yields fell short of early season forecasts due to dryness.
- Beet production in Russia, the Black Sea and Europe suffered because of drought, resulting in higher than expected import requirements.
- Thai cane production for 2010/11 has been consistently revised lower this year owing to the unfortunate mix of early season drought and late season floods.
- Pakistan's production potentials were cut because of the country's devastating August floods.
- Australia's cane crushing and sucrose yields were adversely affected by continuous rainfall throughout the 'dry-season'. Production came in roughly 20% below early season estimates, largely because of cane being left in the fields. Australia, a key global exporter, has been forced to purchase foreign supplies in order to meet existing supply contracts.

India to the rescue?

Just as India sparked the sugar bull market in 2008, they seem the only nation capable of pushing the market substantially lower in the near term. Following the sub-15 million tonne crop in 2008/09 and sub-19 million tonne crop of 2009/10, Indian production this season appears set to come in around 25 million tonnes.

In our opinion, a surprise to Indian production and exports will be the most influential driver of



world prices over the next three months. Indeed, over the past few weeks, some analysts have begun to revise lower their Indian production estimates to ~24 million tonnes. And speculation has mounted that plans for 500 thousand tonnes of Indian sugar exports of may be deferred or cancelled because of strong domestic prices. This speculation has supported global pricing, but so far, the Indian Farm Minister denies they have any such plans³.

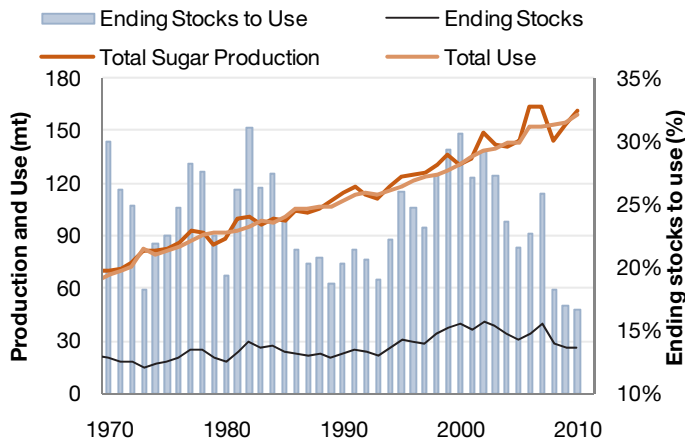
Who else needs watching?

Outside India, our focus is on Brazil and China. Developments in both of these countries has bullish ramifications for our medium term sugar price outlook.

Firstly, Brazilian sugar production – which surged by an average of 7% per annum in the 2000's, including 14.3% growth in 2009/10 and 8% growth in 2010/11 – is widely expected to stagnate in 2011/12. This is because of dryness during 2010, reduced industry investment over the past few seasons and a possible increase in the allocation of cane to ethanol production. (But we should caution some in the industry have anecdotally suggested that these bearish production estimates are overstated)

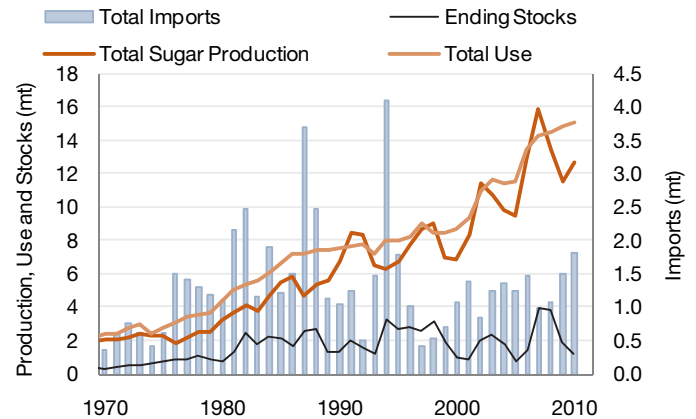
Secondly, developments in the Chinese sugar market are structurally supportive for prices. Chinese sugar consumption has surged in the past decade because of the westernisation of diets. Importantly, Chinese sugar production is struggling to keep pace with consumption growth, and, as a result, Chinese sugar inventories have been eroded while imports have been forced to rise strongly. We expect further strong growth in Chinese sugar imports over the next two seasons as they seek to rebuild inventories whilst also satisfying strong demand growth. If internal production does not rise strongly in future years, China will become the world's most important importer. This would create a structural change to global trade patterns considering over the past 5 years they did not even qualify as a Top 10 importer.

Figure 24: Global sugar supply at critically low levels



Source: USDA and CBA

Figure 25: Chinese sugar supply and demand profile



Source: USDA and CBA

Sugar price outlook

Extremely tight global supplies, slowing (possibly flat) Brazilian production growth in 2011/12, and expected strength in Chinese sugar demand should provide underlying support to sugar prices over the coming 12 months. Uncertainty regarding the state of the Indian industry, from both a production and export perspective, is likely to contribute a risk premium to prices until the situation becomes clearer. The same is true regarding the 2011/12 production impact of recent excessive rain throughout Australia's cane regions.

The primary downside price risk is higher than expected Indian production and exports, and a crop

³ As a point of interest, we clearly recall the experience last February when the Indian's found an additional 3-4 million tonnes of sugar. The global market subsequently collapsed 50-60%. Such an event, whilst not our central theme, is certainly a possibility once again. After all, despite the later than normal finish to the monsoon season, Indian cane weather this past year has been favourable.



exceeding 25 million tonnes is likely to pressure prices. Other downside risks to prices include demand rationalisation, or a stronger than anticipated production growth in other regions.

Prices in 2012 are forecast to come under more significant downward pressure as the global production response intensifies. The 2011/12 global production response is likely to be led by India, which is likely to produce 30 million tonnes of sugar and challenge the 2006/07 record.

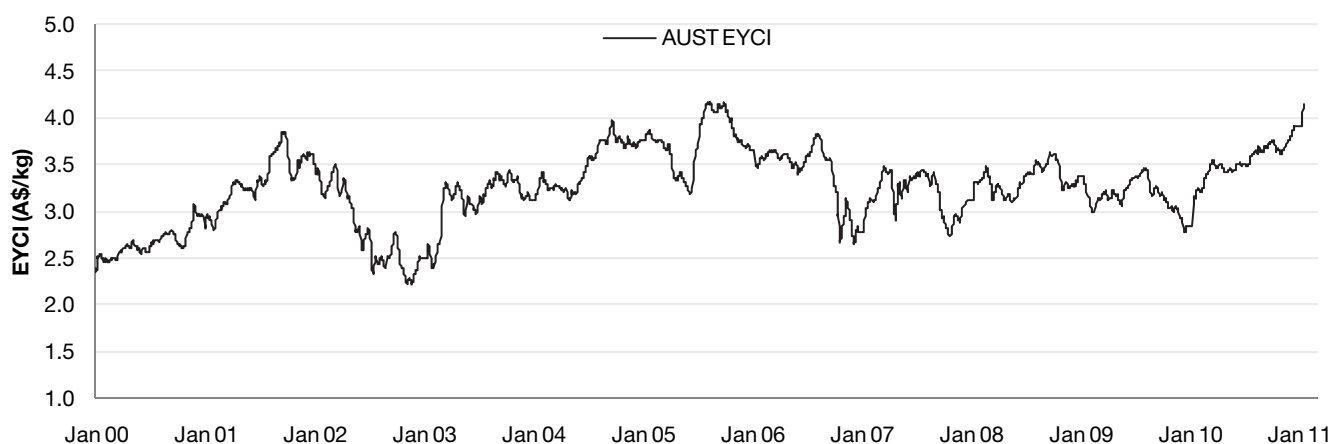
Figure 26: Sugar price forecast

		Current	Forecast (Quarter Average)											
		at 20/01/2011	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
Raw Sugar (ICE)	USc/lb	31.3	29.5	25.8	25.8	22.3	18.0	18.0	16.0	16.0	16.1	16.2	16.0	16.1
	US\$/t	690	650	570	570	492	397	397	353	353	354	356	353	356
	A\$/t	699	641	570	595	531	438	448	410	415	417	419	416	418

Australian cattle market outlook

Australian cattle prices surged during 2010 with the Australian Eastern Young Cattle Indicator (EYCI) rising 43% to A\$4.06/kg, the highest level since 2005.

Figure 27: Australian cattle prices (Eastern Young Cattle Indicator)



Source: Bloomberg and CBA

The transition from drought to widespread rain across eastern Australia throughout 2010 resulted in a turnaround for domestic cattle industry. Producers, faced with abundant pasture availability, sought to rebuild beef cattle herds following years of destocking. The hotly contested restocker market not only contributed to increased young cattle prices, but also to a significant fall in slaughter rates, resulting in lower beef production and higher beef prices.

In the December Australian Commodities report, ABARE noted that the Q3'10 national beef slaughter was 5% below year ago levels, and the national calf slaughter was 13% lower for the period. For the 2010/11 season, ABARE forecast the reduced slaughter rates will contribute to Australian beef production declining 2% to 2.1 million tonnes. However, beef cattle numbers are forecast to lift by 1.6% to 24.7 million head. This rebound in cattle numbers should continue in 2011/12.

Impact of recent Queensland floods.

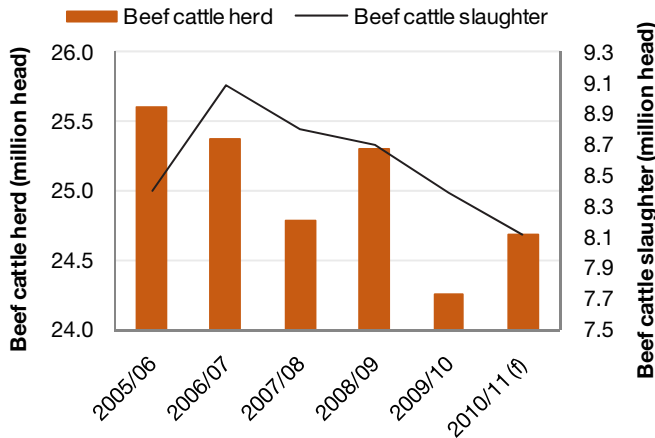
Queensland is Australia's largest beef producing state, accounting for over 40% of Australia's beef production (by value). And the devastating Queensland floods have created near term challenges for the beef industry.

There have been some losses of livestock in the Downs and Fitzroy regions. But, reports of



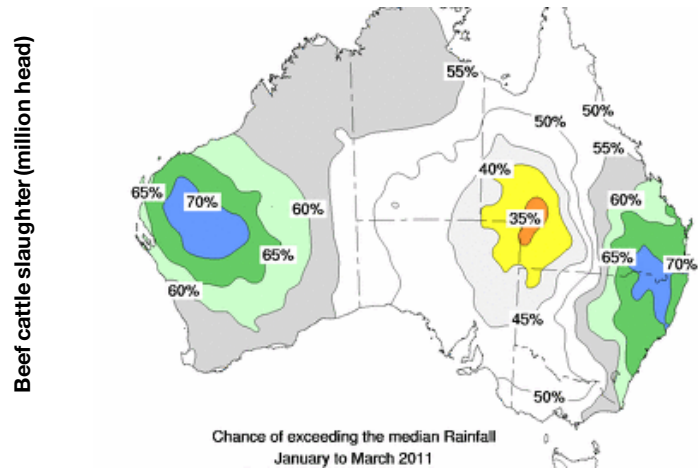
significant losses have been limited. The most significant impact for the industry is through the loss of pasture, the associated need for supplementary feed, and a disruption to the movement of both fodder and animals. Abattoirs will be negatively affected and Australian beef exports in the Q1'11 will be lower than otherwise expected. Nonetheless, as the water subsides strong pasture growth should ensure a recovery in the Queensland beef industry.

Figure 28: Australian cattle numbers and slaughter rates



Source: ABARE and CBA

Figure 29: Australian 3 month rainfall outlook



Source: Bureau of Meteorology (released 17th December)

Beef market outlook

Australian cattle prices will continue to be at the mercy of local weather. However, expectations that the current La Nina to persist through to at least Autumn, resulting in consistent rainfall and ample pasture growth, suggests herd rebuilding efforts will continue. This will underpin the EYCI at historically high price.

Potentially bearish influences for Australian beef cattle prices include the elevated Australian dollar and increased US export competition in key markets of Japan and South Korea. But tight US beef supplies may constrain any competition within key export markets.

Another factor likely to affect the global, and domestic beef market, is the current rally in feed grain prices. High feed grain prices are likely to persist throughout 2011/12, resulting in pressure on livestock feeding margins. This could reduce global cattle on feed placements, and possibly result in some liquidation of the global cattle herd. Under this scenario, there would be a short term boost to beef supply which would pressure prices. While medium to longer term prices would be supported because of future herd rebuilding.

Figure 30: Beef price forecast

		Current	Forecast (Quarter Average)											
		at 20/01/2011	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
Cattle, Aust (EYCI)	A\$/kg	4.06	3.85	3.75	3.58	3.50	3.50	3.50	3.40	3.30	3.31	3.33	3.36	3.38
	US\$/kg	4.01	3.90	3.75	3.43	3.24	3.17	3.10	2.92	2.81	2.82	2.83	2.85	2.87



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