The Hightower Report
Futures Analysis & Forecasting

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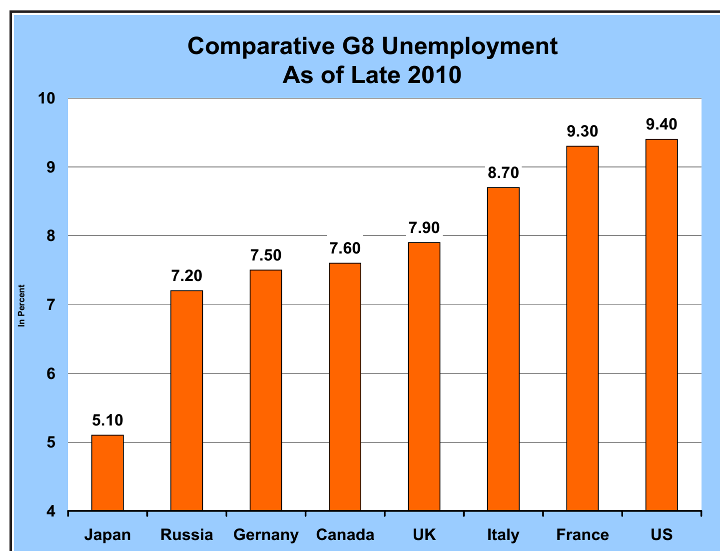
Commodity Outlook for 2011

February 1, 2011

While many economists and talking heads have allowed stubbornly high unemployment rates in developed countries to darken their assessment of the world economy, a lot of progress has been made in putting the sub-prime crisis in the rear-view mirror, and a certain amount of forward momentum is being seen. Certainly, periodic flare-ups of European sovereign debt problems have complicated the global recovery process, but it appears that the ECB and the US can be counted on to make the right decisions, especially after both entities have used up quite a number of the possible wrong solutions. One can't fault Euro-zone and UK leaders for their decisions to move quickly with aggressive government austerity programs, as the marketplace (primarily Germany) was demanding that type of response. However, overly aggressive government spending cuts isn't the short path to growth, and for many EU members the market wasn't inclined to allow them free rein. In a surprise twist of fate, the US was never really held to the same debt and stimulus limits as many other countries, and as a result the Dollar showed some recovery potential toward the end of 2010.



Even though we think that the US economy will continue to see its dominance slip, we expect it to remain an integral part of the global economy. And because the US has so far avoided "tangible" deficit reduction efforts and it in turn has continued to be aggressive with its easing efforts, we have a fairly upbeat and positive economic view toward 2011. Even more encouraging is the potential for the US to shift from the socialist/anti-capitalistic leanings that were embraced by the

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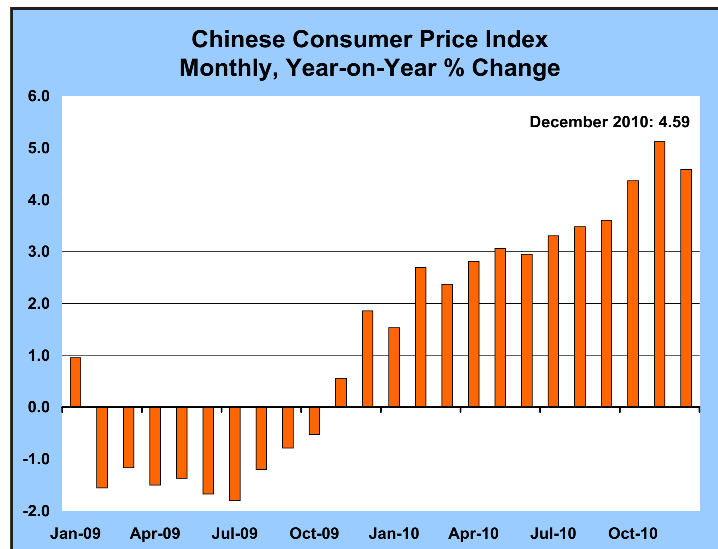
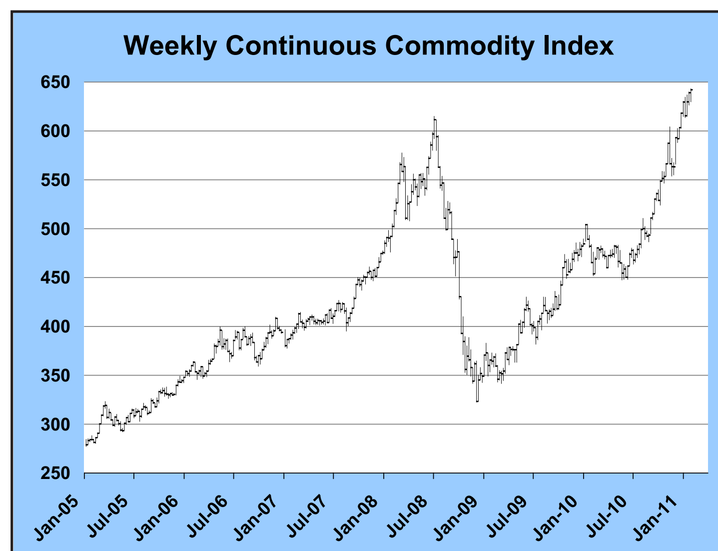
Democratic President and the Democratically-controlled Congress. In fact, even with the lame-duck Democrat House, the US saw efforts to extend the Bush era tax cuts for all incomes.

The US economy seemed to remain on a positive footing into the New Year, but perhaps the pace hasn't been living up to market expectations. With disappointing December Non-Farm Payrolls and US Initial Claims numbers released in January, a bit of macroeconomic concern has resurfaced. For the time being, the dominance of the US over the Euro zone has been tamped down, as auctions of Euro zone debt went off without a hitch and strong numbers from Germany seemed to close the gap with the US.

In addition to news that S&P and Moody's might be poised to reduce the US credit rating, the markets have also been a bit concerned that several US states might be poised for trouble directly ahead. Illinois ignored the calls to reign in spending by passing a last minute, lame-duck tax increase, and the international markets took that as a sign that the US hasn't recognized the seriousness of their debt crisis yet. Therefore, the Dollar seems to be poised to lose some of its strength versus most other currencies. This helped drive the dollar index to the lowest level since November 22nd, and while this might help boost demand for commodity markets, traders remain fearful that the "shift" from the aggressive government spending era and monetary stimulus period of 2008 to 2010 might end with a dramatic shift toward sharp cuts in government spending and sharply reduced spending from state and municipal governments. This may be a drag on economic conditions.

The markets also seem to have found Chinese economic activity to be much more stable than initially perceived, even though China has taken a very aggressive stance in battling domestic inflation. China is expected to see 18 million cars sold domestically in 2010, while the US is only expected to see 12.4 million, which suggests to us that China is quickly becoming the dog that wags the tail in the physical commodity markets. Those seeking accurate signals on the direction of the world economy (as well as commodity pricing) need to shift their thinking from fearing that China will trip up its economic growth by battling inflation to realizing that their growth is well entrenched and that they have no interest in derailing their prosperity.





While global economic growth for 2011 may not be stellar, it could be comparable or slightly better than 2010. Even modest growth is expected to leave most physical commodity prices in a position to see distinct and perhaps aggressive upward moves. Many could post new "all time" highs!

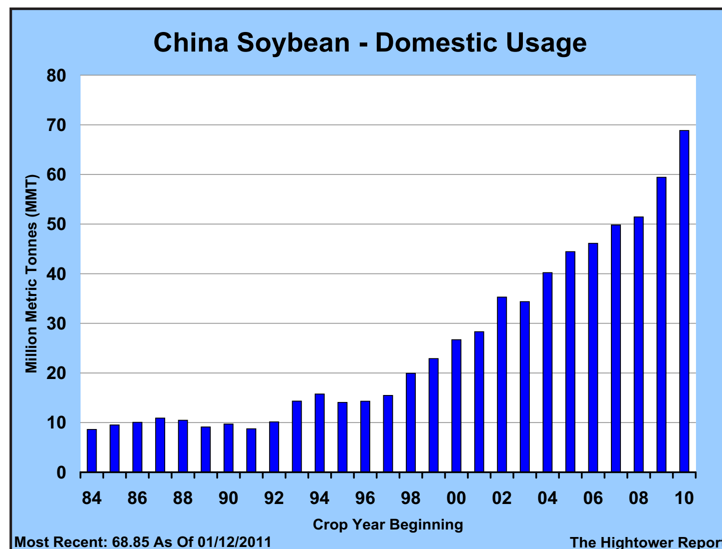
Soybean Complex

Why has China's demand for soybeans been so strong, and can this trend continue? China has traditionally been a major importer of vegetable oils and has occasionally needed to import feed grains. They have developed a huge crushing industry, allowing them to convert soybeans they grow (plus any imports) to oil for human consumption and to meal for high protein livestock feed. The soybean has been the ideal commodity for the Chinese, helping them meet their needs for a high protein ingredient to blend with other feed grains for their livestock and helping them meet their steady rise in vegetable oil consumption. Demand continues to grow at a very impressive pace, as does their reliance on foreign supplies. As that continues to grow, any disruptions in production from South America or the US will likely spark volatile price action in the soybean market.

Even with a forecast for a record US crop and record high world soybean ending stocks in the summer of 2010, traders saw the bullish demand trend from China and some uncertainty due to dryness in South America ahead of plantings as reasons to keep the market in a major uptrend into the harvest. Even a record fast harvest and improving weather for planting in South America failed to slow the uptrend, with nearby soybean futures moving from $9.40 per bushel in late June 2010 to $14.29 into early 2011.

On top of the surging demand for soybeans from Chinese crushers, the sharp drop in the US dollar, the large amount of US dollar reserves held by China, the need for China to rebuild their state soybean reserves and the longer-term uptrend for China's consumption are all factors which might encourage China to build inventory. Weakness in the dollar, an inflationary tilt for many commodity markets, and the longer term growth outlook for soybean demand has attracted increased interest by fund traders as well.

For the 2009/10 season, China's soybean imports reached a record 50.34 million tonnes, up 22.5% from the year before. The USDA is projecting imports of 57 million for the 2010/11 season, and some private forecasts are up to 62 million. This is the primary reason that soybean prices have remained strong in the face of a fairly hefty supply outlook this year. As of late January, US soybean export sales for 2010/11 had reached 86.3% of the USDA's forecast for the entire season, well ahead of the 5-year average of 73.9% for that time of the year. Soybean oil exports have reached 85.3% of the forecast for the season vs. 37.8% as normal for this time of the year. If oil or meal exports are revised higher, the USDA may be forced to raise the crush pace. If soybean exports are raised again, the higher export or crush numbers could tighten US ending stocks even tighter.



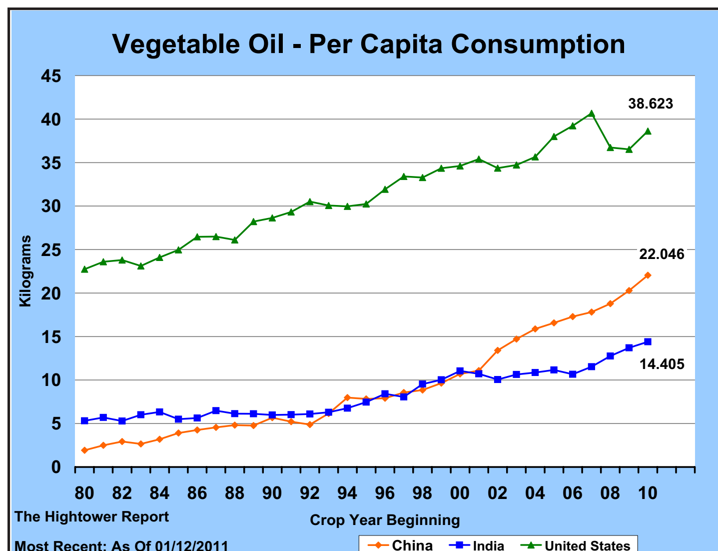
The USDA January reports were considered supportive for soybeans, with US ending stocks pegged at just 140 million bushels versus 165 million the previous month and 151 million last year. This would be the lowest ending stocks level since the 2008/09 season. The stocks/usage ratio is now the lowest since the 1965/66 season. World ending stocks were pegged at 58.28 million tonnes, down from 60.12 million tonnes last month and below trade expectations near 58.5 million. Argentina's production was pegged at 50.50 million tonnes vs. 52 million tonnes the previous month, but many traders are looking for their production level to fall to 46-48 million tonnes this season.

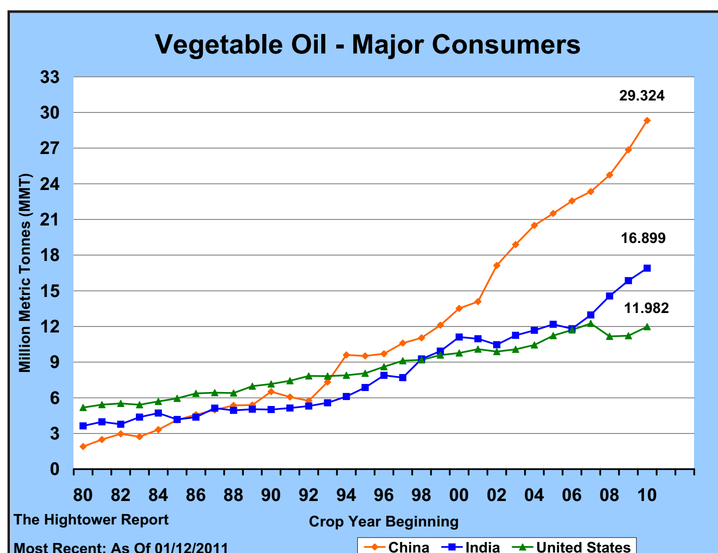
The USDA believes China's soybean production this year will be around 14.4 million tonnes, while official Chinese estimates are closer to 14.8 million. The enclosed chart shows the dramatic growth in demand from China over the past decade. There is no reason to expect China's demand to decline unless there is a collapse in the world and/or Chinese economies. Without such collapse, the movement of hundreds of millions of people in China, India and Indonesia to higher standards of living should help keep demand trends strong for China and world in general. We point this out to suggest China is not the only place where vegetable oil and feed grain consumption will see strong growth. Growth patterns in these other countries are also quite strong, and per capita consumption has room to grow, especially when compared to US consumption.

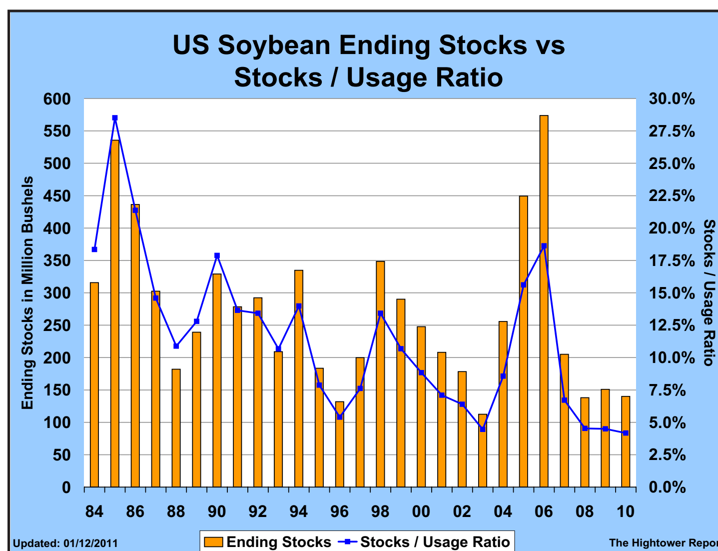
Soybean Complex *continued*

Do not assume that vegetable oil demand will increase by 8% when you see the economy expanding at 8%. It may increase even more. It is astounding to think that China's domestic consumption of soybeans has doubled in the past 7-8 years, but the growth in per capita consumption helps explain the dramatic rise. In the year 2000, per capita consumption of vegetable oils was about 34.6 kilograms in the US, 10.7 in China and 11.0 in India. US total consumption was about 9.8 million tonnes, China's at 13.5 and India's at 11.1. For 2010, China's consumption had more than doubled to 29.9 million tonnes. During the same period India's consumption increased to 16.4 million tonnes and the US rose to 12.1 million. As China's (and India's) economies advance, we would expect per capita consumption to continue to grow and total vegetable oil consumption to grow at an accelerated pace.

While the basic supply/demand fundamentals for the US for the 2010/11 season are potentially explosive into the summer of 2011, trade estimates for spring plantings are pointing to lower, not higher, plantings than last year. This may end up being a very powerful force for the February/March time frame. If we see the same planted area and usage this coming year as they were for 2010/11 and yields are near the 5 year average, ending stocks would come in at just 45 million bushels. This would be an unacceptable situation for the US soybean market. For this reason, we think new crop November soybeans will likely see a strong upward thrust during February and March to allow for the possibility of some increase in planted area. We see the soybean market near $15.62 by the end of 2011 and would not rule out highs near $19.92 if there is any hint of a weather problem.

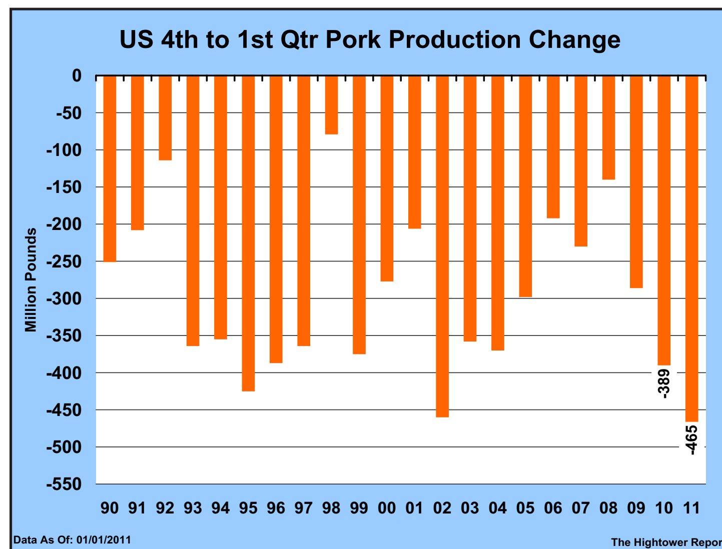




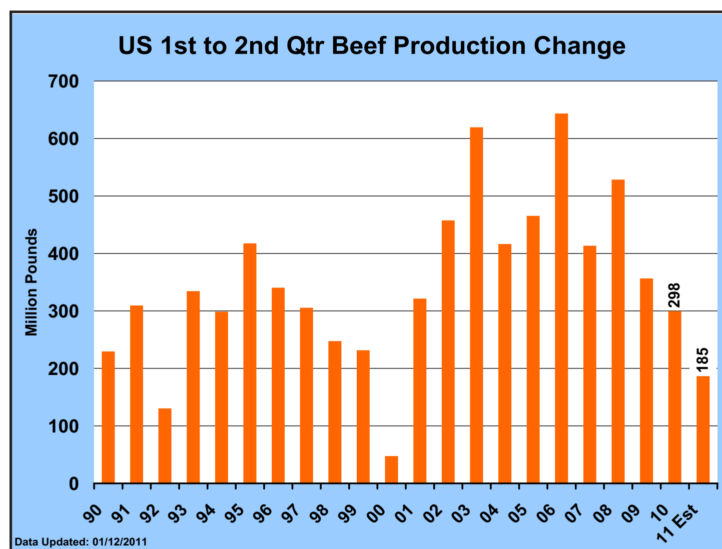


Livestock

The combination of a lack availability of beef imports into the US from Australia and to the global market from Argentina, expanding US exports, a significant shift lower in US beef production expected for the next six months, and the possibility that US non-fed cattle slaughter will slow from its rampant pace of the past year leaves the supply outlook for cattle tight. In addition, expanding US and world economies and an inflationary tilt to commodity markets in general (which makes in easier for retail and thus wholesale prices to rise), are seen as bullish forces. While the recent jump to record high prices could slow demand for cattle, our observation in the past has been that when a commodity market surges to new all-time highs, it generally continues to advance to a more significant peak, 15-30% above the old highs, before topping out.



Hogs pushed to new contract highs in late January as the surge higher in pork values, led by a sudden need for dramatic imports from South Korea, helped to spark the rally. South Korea is battling a jump in foot-and-mouth disease, which is deadly to animals but does not spread to humans. As a result, nearly 24% of their hog herd has been culled, and the government has dropped import tariffs to zero for the first 60,000 tonnes of pork delivered by June. China is planning to expand imports of agricultural commodities, and the Minister of Commerce recently mentioned that they are currently considering expanding stockpiles of meat, sugar and other necessities. Pork production is also tightening, and a shift to a more robust export pace could set the stage for a significant drop in per capita supply, down to 46.9 pounds in 2011 from 47.8 pounds in 2010 and 50.1 in 2009. If the USDA has underestimated the US export pace, per capita supply could end up being even tighter.



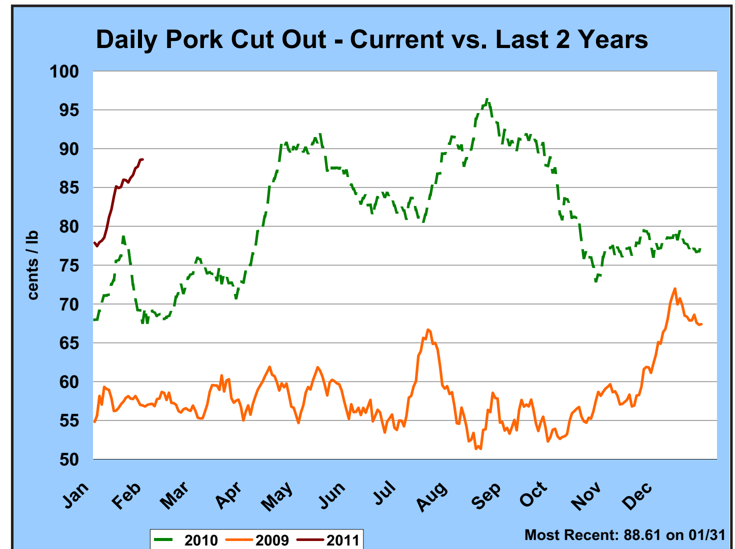
The USDA is forecasting beef production in the 1st quarter to be down 435 million pounds from the 4th quarter of 2010. This compares with a decline of 175 million for the same period last year and an average decline of 200-300 million. If this happens as expected, it will be the second largest 4th to 1st quarter decline since 1980 and the third largest going back to at least 1970. It suggests that the seasonal tendency for cattle prices to rally into the spring could be even stronger than normal this year. From the 1st to the 2nd quarters, beef production is only expected to increase by 185 million pounds. This would be the lowest increase for that period in 11 years. This makes for a positive setup for cattle prices, especially the April and June contracts, as the market adjusts to lower production in 2011.

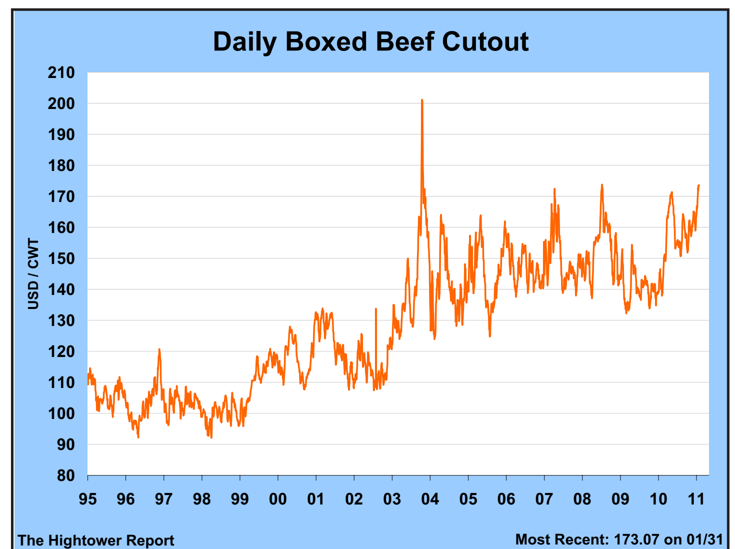
For pork, the USDA is forecasting 1st quarter production to be down 465 million pounds from the 4th quarter, which is the largest drop since 1984 and the second largest back to at least 1970. It would also suggest that the typical "up" seasonal in hog prices into the spring could be stronger than normal this year. From the 1st to the 2nd quarters, pork production is expected to decline by 320 million pounds. This is a larger than normal decline and is also considered to be supportive. Hog weights remain high, and production in December and early January was higher than expected, but pork product prices still pushed sharply higher, with pork cutout values reaching their highest levels since October.

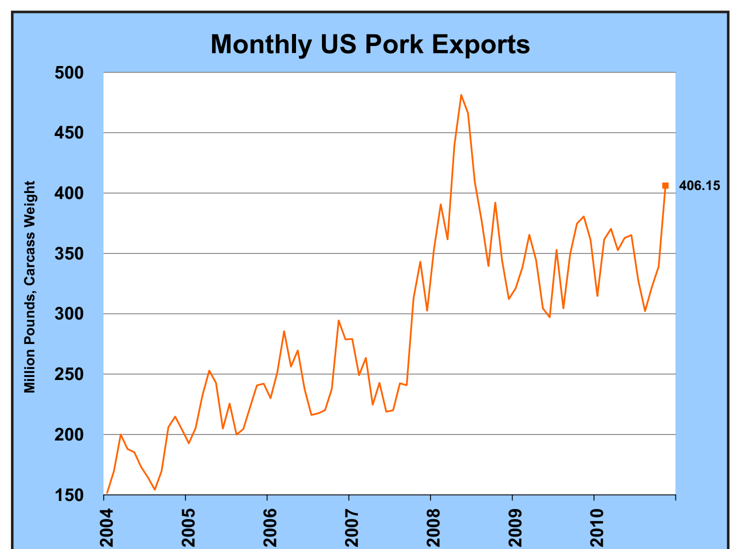
Livestock *continued*

In December, China started importing beef from the US for the first time since 2003. Beef production in China for 2011 is expected to slip 2% to 5.45 million tonnes. The USDA is predicting that US beef exports for 2011 will be about steady with 2010 at 2.3 billion pounds, but many traders are calling for a stronger export pace, especially if China and South Korea start to boost their import pace. Slow exports out of Argentina and Australia have helped support the prices of lower-grade beef cuts and hamburger, and this has provided significant support to the overall beef market. Boxed beef cutout values reached $172.81 in late January, which was the highest level since July 11, 2008.

Monthly pork exports for November reached 19.8% of total production and they were the highest since the spring of 2008. The USDAis forecasting 2011 exports to be up 9.1% from last year. South Korea has culled nearly 2 million pigs and reduced the pig and cattle population by about 15% so far in attempts to stop foot and mouth disease from spreading. Traders see this as a reason to expect a stronger US export pace ahead.





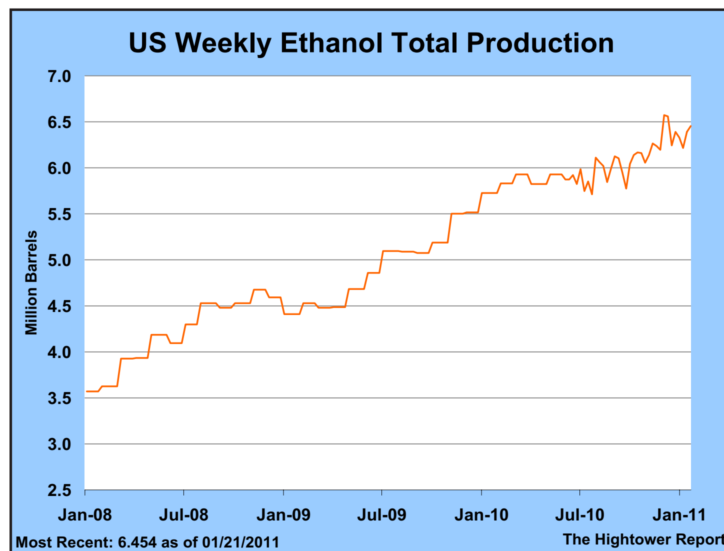


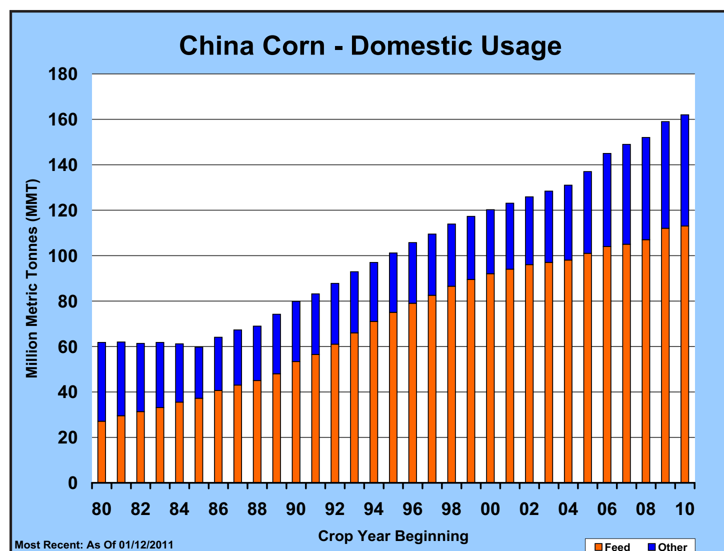
Corn

The corn market faces plenty of potential news items coming out of Washington in the next few months. The political fight over ethanol subsidies in Congress, the CFTC fight to control speculation in commodity markets, the EPA's direction on corn ethanol and other bio-fuels, and the possible increase in ethanol blending are all potential market-moving forces. While these events will bring some clarity, investors are also trying to determine if corn will move along with other commodity markets toward massive increases in world demand due to globalization, and if so, just how the world will move to increase production to feed this demand. If India, China, Indonesia, Brazil, Russia and others continue to see internal growth and expanding incomes for their previously impoverished citizens, those incomes are likely to be spent on food and food products. Not too many years ago China and the US produced about the same amount of pork. In 2011 China will produce more than five times as much as the US.

While some try to make the case that monetary stimulus efforts from the developed economies, currency fluctuations and increased speculator interest are the primary reasons for higher food prices, we contend that growing consumer demand is the key issue. Even the Starbucks CEO is ready to blame speculators for pushing coffee prices to a 13-year high, despite ample evidence of a steady rise in demand, production difficulties in Colombia and very tight beginning stocks for the 2010/11 season. This atmosphere, plus a move to cut government costs, suggests that ethanol produced from corn may not be a source of growth for corn demand in the future. But is this a reason to believe that world demand for corn will not continue to grow?

The clash between government and free market forces and the potential assaults on speculation could keep corn bears interested in the weeks ahead, but we continue to see the potential for extreme tightness this year, a need for further plantings this spring and strong import demand from China (despite their having a bumper crop again this year) as reasons to buy corrective breaks in corn. Both China and Russia emerged as potential large buyers of Argentine corn on the late November 2010 break. We may see sales of as much as 8 million tonnes to these two traditional feed grain exporters during 2011. Argentina exported a record 17.5 million tonnes of corn last year, and if they sell 8 million tonnes to China and Russia this year, their other customers will be forced to either go without or come to the US. If we assume that only 4 million tonnes of the additional demand is absorbed through increased US exports and the rest of the supply/demand table remains unchanged, US ending stocks could slip to extremely





tight levels. As it turns out, there are probably 8-10 million tonnes of feedwheat from Australia available to these new feedgrain buyers, and while this is still a positive for total feedgrain demand, it may help hold down expected improvement in US corn export demand.

USDA December 1st corn stocks came in at 10.04 billion bushels, which was down 27 million from trade expectations and down 862 million bushels from last year. The number suggested that usage was high for the first quarter of the marketing year, and it left the market with a strong opinion that price rationing was not occurring. For the final crop production report of the 2010/11 season, released on January 12th, the USDA pegged US corn production at 12.447 billion bushels, with a yield of 152.8 bushels/acre. This was down

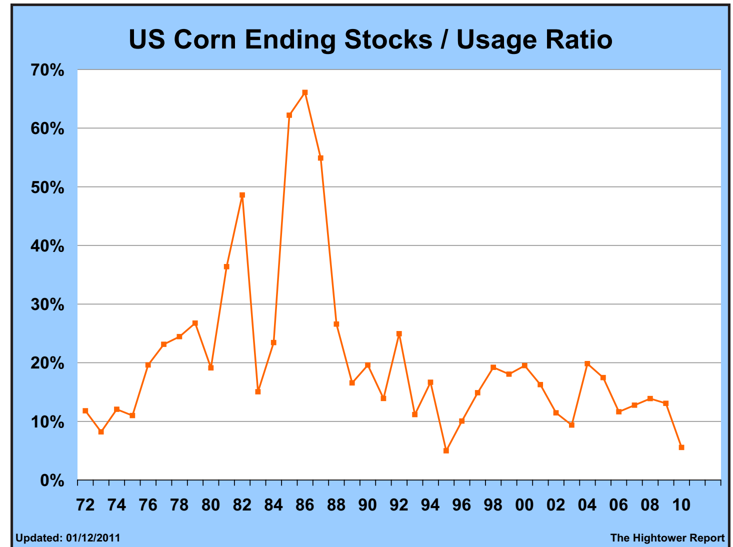
Corn *continued*

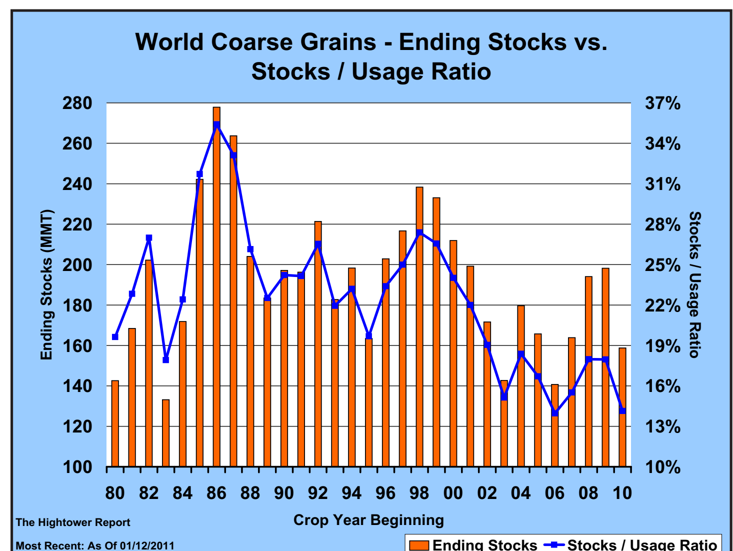
from the previous estimates of 12.54 billion bushels and 154.3 bushels per acre and last year's yield of 164.7 bushels/acre.

In the January USDA Supply/Demand report, US ending stocks for 2010/11 were revised down to 745 million bushels from 832 million bushels estimated in December. These were lower than trade expectations centered around 780 million. Total usage numbers were left unchanged, with ethanol usage up 100 million bushels and feed usage down 100 million. This put the US ending stocks to usage ratio at just 5.5%, which was the second lowest back to at least 1960. (The lowest was 5.0% in the 1995/96 season.) Just last year the ratio was 13.1%. The 10-year average is 14.5%.

In the January USDA report, world ending stocks came in at 127 million tonnes, lower than trade expectations and down from 130 million in December. World coarse grain ending stocks were pegged at just 158.79 million tonnes from 198.8 million in 2009/10. This pulled the stocks/usage ratio for feed grains down to 14.3%, the lowest since 2006/07 (13.96%) and the second lowest since 1973. Argentina's production was revised down by just 1.5 million tonnes to 23.5 million, but many traders have already pushed their forecasts down to the 19-20 million-tonne level. Just a few months ago, Argentina was expected to see record production of 25 million tonnes and record exports of 17.5 million tonnes. Traders will continue to monitor the weather situation closely in Argentina, but much of the region saw very stressful conditions into the key pollination cycle, and many traders believe permanent yield damage occurred. The US Grains Council believes China will import 2 mmt this year and as many as 15 mmt (nearly 600 million bushels) per year by 2015.

The corn market will need to move to a high enough price level to see evidence that the high price is slowing demand. In addition, the market must remain high enough to encourage producers in the US to plant an additional 3-4 million acres for the coming season. If China decides to build their strategic reserves or if there is a hint that the US will see a significant jump in plantings (possibly due to a wet spring), corn would be poised to move up to a different price level. While the market may settle back towards $7.00 by the end of 2011, we see a strong potential for it to make a run at $8.34 this year.

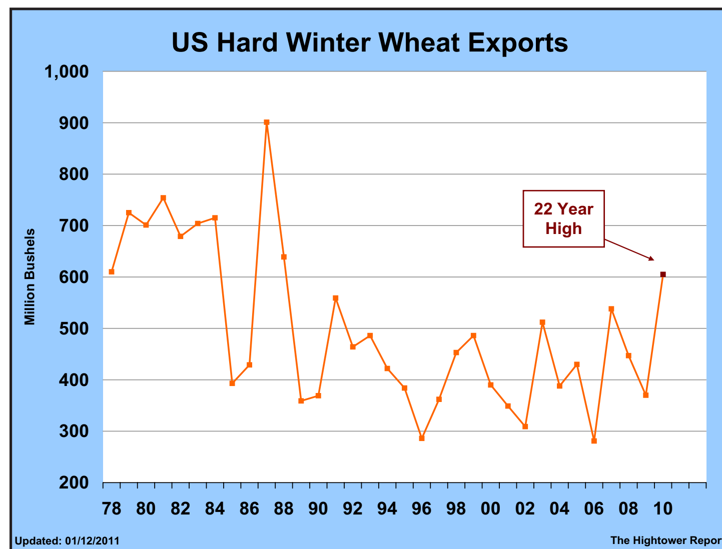


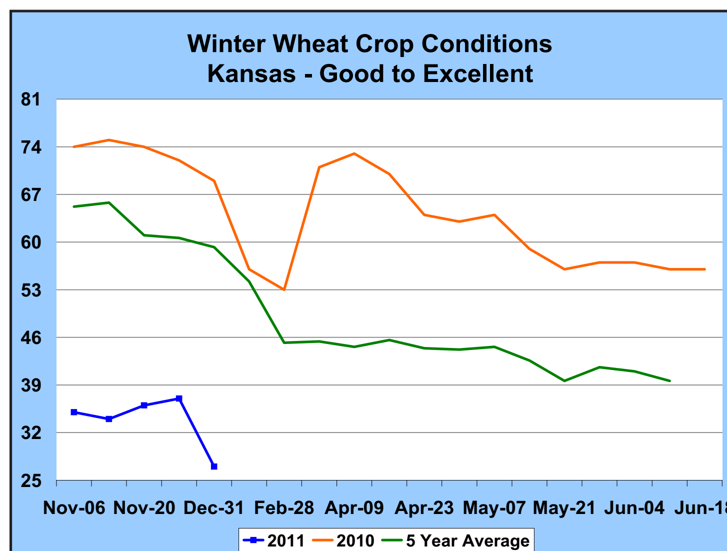


Other Agricultural Markets

The January USDA reports for the grain and soy markets confirmed tightening supply and strong demand and helped drive corn and soybean values to their highest levels since July 2008 and July KC wheat to new contract highs and above $9.00 for the first time since July 2008 as well. With ending stocks for corn and soybeans now pegged close to pipeline minimum levels, the market's job over the near term is to move to high enough levels to slow demand and ease tightness at the end of the season. The market's other job is to provide high enough profitability on paper to give producers an incentive to increase plantings this year in order to avoid tightness issues next year as well. While wheat stocks are not considered tight, high quality wheat is in tight supply, and the emergence of food-inflation based protests and riots in Tunisia, Algeria, Egypt and other places has helped spark additional and unexpected demand for wheat for the short term. This type of food-policy demand is also likely to support rice, sugar and vegetable oils and dried milk.

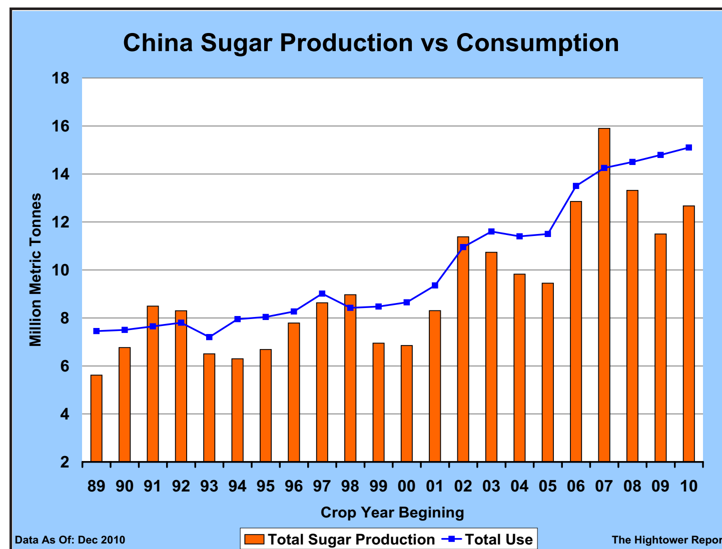
WHEAT: Traders were keying in on the winter wheat plantings for the January reports, and the USDA showed total plantings at 40.99 million acres compared with trade expectations near 40.94 million acres and 37.335 million last year. Hard red winter wheat plantings came in at 29.60 million acres vs. expectations around 30.2 million, so the report was considered more supportive to Kansas City wheat than Chicago wheat. Soft red winter plantings were estimated at 7.76 million acres versus expectations near 7.2 million and 5.27 million last year. For the January supply/demand report, US ending stocks for 2010/11 came in at just 818 million bushels, which was below expectations of around 850 million and down from 858 million estimated last month and 976 million for 2009/10. For the world report, ending stocks were pegged at 177.99 million tonnes, up from 176.72 million tonnes estimated last month and trade expectations near 174.6 million. Argentina's production was revised higher, and Australia's was left unchanged. December 1st stocks came in at 1.928 billion bushels versus 1.782 billion bushels in 2009. Dryness remains an issue for US and China winter wheat crops. As of January 1st, the Kansas crop was rated 27% in good to excellent condition versus 69% last year and the 5-year average of 59%. Ideas that demand will remain strong over the near term, especially for US wheat, and fears of dryness issues in the US and China, should help provide underlying support.





Other Agricultural Markets *continued*

RICE: The USDA reports for rice do not show a significant tightness ahead, but with increased emphasis on food security and with inflationary pressures on food prices, the market may see the need for rice prices to move sharply higher this year just to play catch-up with the other grains and avoid losing significant planted area to other crops around the world. In the US, producers see cotton and soybeans as much better alternatives to planting rice. While the US produces just 1.6% of the world rice crop, US exports represent 11.7% of the world export market. US and world ending stocks are not tight this year, but more and more traders see significant tightness in the years just ahead if producers shift to other markets or if there is a significant weather problem for one of the world's key producers, such as China, India, Indonesia, Vietnam or Thailand.



SUGAR: The sugar market pushed to a new 30-year high in late 2010 and consolidated for much of January. The market appears to be consolidating last year's gains, but with extremely tight stocks and a near record low stocks/usage ratio, futures remain vulnerable to any shift in attitude that might spark increased the desire on the part of end users to hold inventory. While the weather in Brazil over the past several months has been favorable for a decent crop in the 2011/12 season, traders expect to see some damage from last year's drought, and many traders see cane production about the same as last year, maybe slightly higher. In addition, traders expect Brazil to use more of their cane crop for ethanol production. This means that other key world producers need to have higher production in order to avoid further tightness ahead. Australia saw significant flooding, which lowered their exportable surplus. And while Thailand attempted to expand production significantly last year, the weather just did not cooperate.

China is seeing another poor crop year with too much cold and sleet in the southern China growing areas, and this will likely mean another year with a production deficit, their third in a row. Demand for imports from China is likely to increase dramatically this year, as China faces a deficit of more than 2 million tonnes. On top of that, China may also feel the need to replenish its state reserve stocks, which are thought to be down to around 1 million tonnes from 2.9 million in 2009. A more typical level would be 4 million tonnes or about a three-month supply. Some traders believe reserves are currently down to fewer than 500,000 tonnes. China is planning to expand imports of agricultural commodities, according to its Minister of Commerce, and is currently considering expanding stockpiles for meat, sugar and other necessities.

Russian production from beets was also lower last year due to poor weather. Russia import tariffs are at $140/tonne presently, but traders believe that the tariff will drop to $50 in March if approved by the executive committee in February.

Look for a continued uptrend for sugar ahead with the February to April time frame looking to be the tightest "if" the weather remains favorable. India was expected to fill the void on the world market before new crop sugar is available, but under the current situation, it appears unlikely that India will aggressively export sugar or any other food commodity this year.

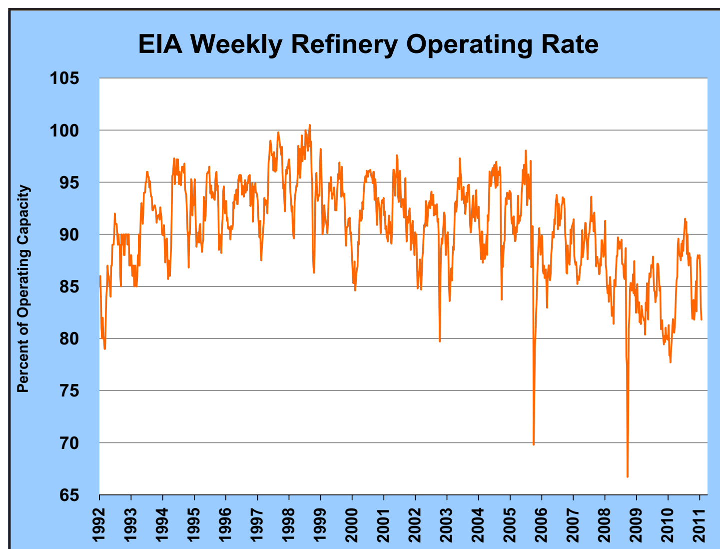
Energy

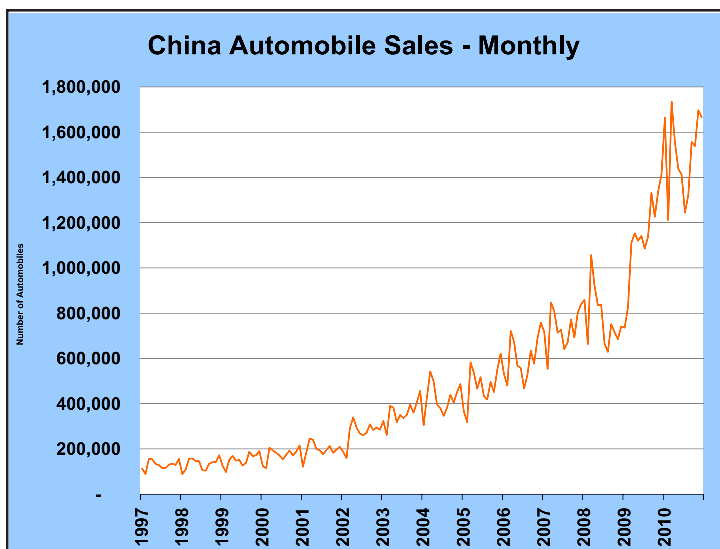
Regardless of your opinion on energy prices at the beginning of 2011, you have to ask yourself how nearby crude oil prices were able to return to the vicinity of $90 per barrel in late 2010 in the face of relatively high physical supply levels and a historically low US refinery operating rate. One would have thought that the US refinery rate hovering down around the 80% level for much of the 4th quarter would have kept pressure on crude oil prices. However, we think that a stubbornly low US refinery operating rate combined with a much stronger than expected recovery in the global automobile industry indicates that energy price action in 2011 is going to be dominated by the product markets.

While China tended to keep its refinery operating rate at record levels for a large portion of 2010, Venezuela, a major US gasoline supplier, saw its refineries running at only 75% of capacity. Clearly a ramping up of gasoline consumption in China and India alone are already having an impact on world energy prices. The failure to put enough global refinery capacity in place could mean that gasoline will end up challenging crude oil as the primary determinant of energy prices.

Chinese car sales totaled 13.6 million units in 2009, and the China Association for Auto Manufacturers (CAAM) initially forecasted 2010 sales to reach 18 million in 2010. A logical assumption would be for even higher 2011 sales. Some sources have forecasted that ownership of cars in China was only about 6% in 2010. Therefore it would be premature to think that gasoline demand in China is anywhere near topping out. Some reports have suggested that China's dependence on foreign oil will rise 50% or 60% from current levels due to the expected increase in drivers in the years ahead. Chinese crude oil imports in January 2011 totaled 17.1 million tons, up 33.4% from the previous year's levels. Expectations in 2011 are for China to import 5.27 million barrels per day of crude oil, which is up 10.2% from 2010. A 50% increase from there would put imports at 7.90 million barrels per day and rival the 8.88 million barrel per day pace of the US.

Another potential bullish development for energy would be a sharp reduction or even elimination of subsidies for ethanol production, as being discussed on Capitol Hill. If such a measure passes, it would have the potential to cause a significant decline in ethanol supplies, which in turn would increase the demand for unleaded gasoline. Ethanol blend rates averaged 8.5% of gasoline in 2010 but were on their way to a 2011 goal of 11%. Lowering ethanol production would effectively reduce US gasoline supplies and in turn vault our dependence on foreign oil. Government pundits might suggest that mandates will ensure ongoing production of ethanol, but that won't be the case over the long term if corn input costs soar and ethanol production becomes unprofitable.

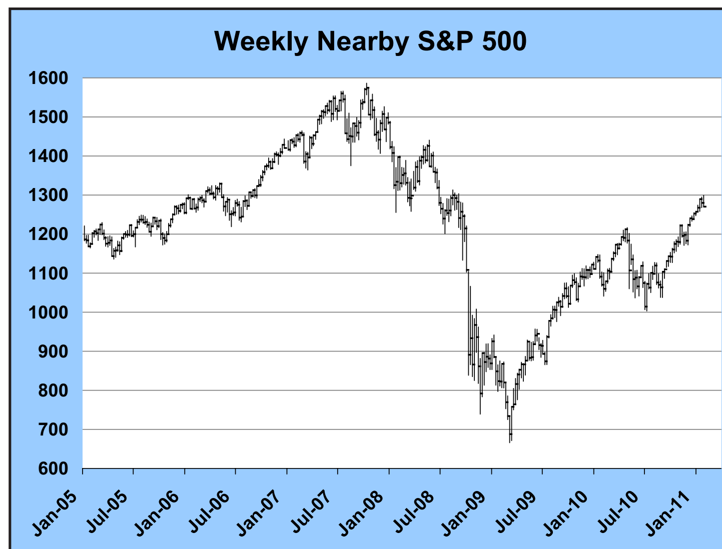




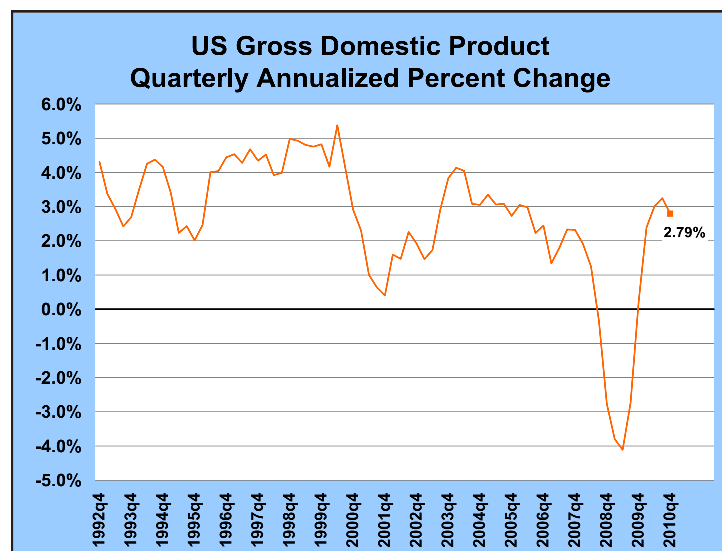
As of mid-January US gasoline inventories weren't particularly tight, but increased global competition for gasoline supplies in the year ahead could cause crude oil prices to return to $100 in the first half of 2011.

Stock Indices

The end of 2010 saw US equity markets bounce back to levels not seen since autumn 2008. This appears to have been the result of improving macroeconomic hopes as well as ideas that easy money policies are likely to remain in place. With the return to price levels not seen since the financial market meltdown, it is possible that markets are now enjoying the fruits of the measures taken to jump-start economic growth. A portion of the gains likely came from favorable corporate earnings that were the result of aggressive cost cutting, but toward the end of 2010 some top-line revenue gains were actually being made across certain industry groups.



For equities to continue to climb in 2011 as they did in the second half of 2010, it will probably require some clear forward motion in the economy and perhaps evidence that the Fed isn't going to prematurely pull back on the reins. It should be noted that some of the 4th quarter gains could have been the result of inflationary expectations, as the initial stages of inflation can benefit equity prices and corporate incomes. In our opinion a number of companies are likely to post strong 4th quarter 2010 and 1st quarter 2011 earnings because the inflationary environment allowed them to raise prices in advance of their costs rising.

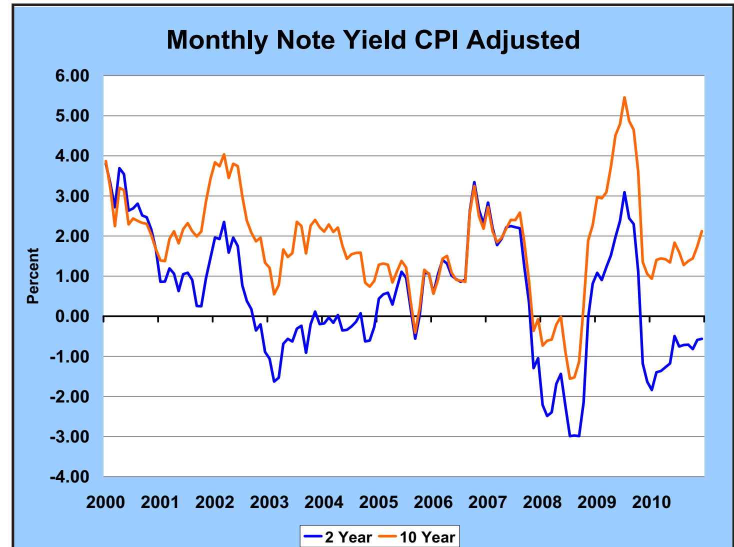


Given the ramping up of a number of commodity prices in the second half of 2010, it would seem like rising material costs could eventually become a threat to larger brick and mortar companies. Therefore, we think that the tech sector and the NASDAQ might easily outperform the larger cap sector in 2011. In the past equities have managed to rally as long as the market was expecting interest rates to remain low, but the real test of equity prices might come in the second and third quarters, when we think the Fed will be feeling real pressure to stem inflationary psychology.

Many US companies have exited the recession "lean and mean" after the cost cutting efforts of the last several years, and that combined with high productivity levels and a favorable rate environment should leave the bulls with an edge, as it could provide some favorable earnings surprises even in the face of only a modest recovery. On the other hand, it will take a very masterful Fed to facilitate the recovery while keeping inflationary expectations in check, which could make 2011 an extremely choppy year for stock prices. We expect the uptrend in stocks to extend well into the 1st quarter of 2011, but prospects for the bulls should dim as the calendar unfolds.

Treasury Markets

The debate on whether or not the US Treasury market was in the midst of a bubble remained in place for most of 2010, but with yields rising from the mid August lows to the middle of December, it would appear that the Treasury market has already started to perceive some sort of an "end game" for the multi-decade bull market. "Big picture" traders may have already found their signal that a top is in when an auction for 2-year Treasury notes in November saw what amounted to a negative inflation-adjusted rate of return. In other words, those buyers of 2-year Treasury paper were willing to accept a mere 0.5% return during the coming two years. When that is adjusted for even a low inflation forecast, it technically leaves those holders with the potential for a negative rate of return on their "low risk" investment!



We suspect that the increase in Treasury yields since the start of the 4th quarter of 2010 would have been much more significant if it were not for lingering Euro zone sovereign debt issues, the potential for an expansion of US quantitative easing efforts and weaker than expected US Non-Farm Payroll results from early December and from early January. In the end, the reality of the Treasury market environment during the last quarter of 2010 was that even fewer non-government buyers were stepping up to the plate, with the US government forced to become the primary buyer.

In retrospect, it appears that the personality of the US Treasury market noticeably shifted to a less bullish resolve after the August 2010 peak. The first example was the actual kick-off of the Federal Reserve's new quantitative easing program (the "QE2"), in which the market saw only a fleeting rally and then had a distinct technical failure. Perhaps the trade was disappointed that the Federal Reserve decided to buy only $600 billion in securities and to spread those purchases out over an 8-month period. Therefore the Fed didn't exactly use a "shock and awe" strategy, especially since they also suggested that the program could be adjusted on a monthly basis. Through the early part of 2011, however, the Fed has maintained both the side and the scope of the program. With many in the market doubting the ultimate effectiveness of the QE2 program to begin with, and with the size and concentration diluted, it's not surprising that the market's initial response was anemic.

Other examples of the tempering of bullish sentiment for Treasuries have been the mostly limited reaction to a combination of renewed Euro zone sovereign debt concerns and lingering doubt on the pace of the US recovery late in 2010. In fact, a Fed-conducted survey showed 30 economists forecasted the US unemployment rate at the end of 2011 to be as high as 9.2%, but even that failed to embolden the bull camp.

The Treasury market also saw political developments at the end of 2010 that seemed to make it more difficult to reduce the near-term expansion of US Treasury supply. The extension of Bush-era tax cuts along with reduced payroll taxes is likely to provide some tangible benefit for the US economy, but during the early part of this year those actions could end up reducing tax receipts and in turn add to Treasury supply going forward.

While a significant portion of the recent decline in Treasury prices has been the result of inflationary pressures, we continue to feel that inflation is clearly not the dominant influence. However, it's a pretty good bet that the rapid rise in commodity prices will become an increasingly important

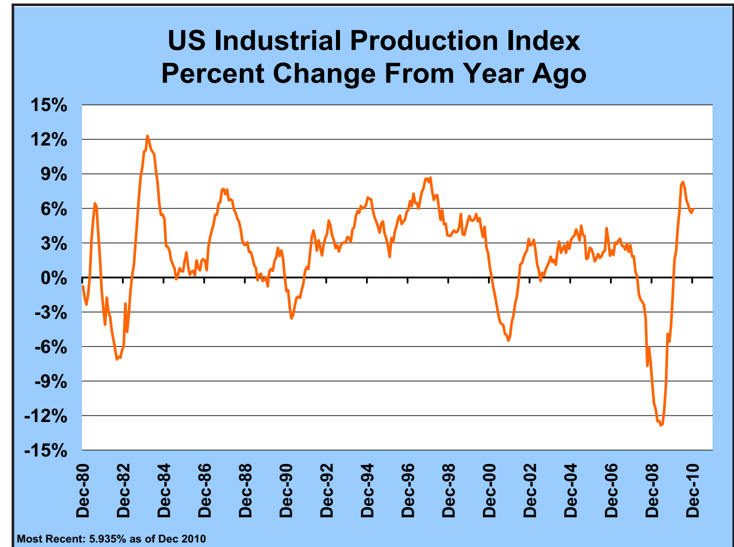
Treasury Markets *continued*

element for Treasury pricing during 2011. Nearby crude oil prices already traded above $93 per barrel during the early part of this year, despite fairly slack global economic activity, and grain prices are poised to send a shockwave through food markets. While Federal Reserve Chairman Bernanke has indicated he is certain that the Fed could arrest inflationary pressures that resulted from their policies, we think the Fed will have little if any capacity to head off a classic, physical commodity inspired inflationary bubble over the coming quarters.

The supply of US Treasuries will likely continue to expand, while at the same time demand appears just as likely to contract. Even though the Fed stands ready to head off inflation, it is possible that market forces will sense impending inflationary pressures and begin to push up real interest rates. In fact, the biggest obstacle for the Fed in the 1st quarter of 2011 might be fighting a premature rise in short term interest rates, and that in turn could prompt them to up their QE2 ante!

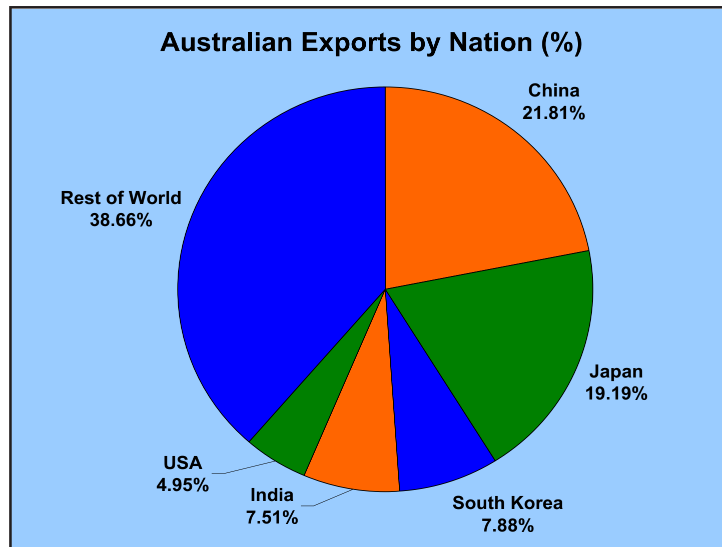
More than likely the Treasury market has already put in a top, with the key question for 2011 being how much rates will initially rise. These events could force the Fed into a position in which they have to catch a falling piano.

Our price forecast for 2011 is for US Bonds to fall faster than Notes. We look for 30-Year Bonds to reach down into a 120-00 to 115-00 trading range by the end of the 1st quarter or perhaps as late as the middle of the 2nd quarter.



Forex

The key factor for the currency markets for 2011 will be the success or failure of monetary and fiscal measures that were created to further stimulate the world economy. Most of the market's attention could remain focused on the Fed's quantitative easing measures introduced in early November 2010, especially since the Fed has hinted at expanding the size of this program over the past few months. The most recent FOMC meetings have confirmed that the Federal Reserve will maintain the size and scope of the "QE2" program, but any expansion during the first quarter of 2011 could weaken the Dollar beyond the losses seen during January and in turn could provide another leg up for physical commodity markets.



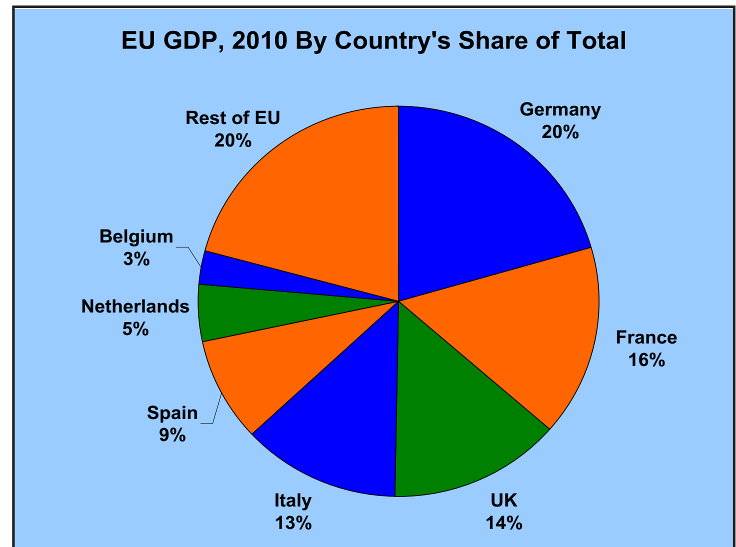
The bipartisan deal to "trade" an extension of Bush-era tax cuts for an extension of unemployment benefits is likely to add to the potential for a recovery in the US economy, but the ongoing concern with the US deficit is likely to weigh on the Dollar during the first half of 2011. The Dollar has continued with a pattern of volatile trading very early this year, reversing gains from a strong rally to reach its lowest levels since mid-November. The key factor in this turnaround has been inconsistent US economic data, which began this pattern early in January with December payroll figures failing to match market expectations. Therefore, we see some initial weakness in the Dollar early in 2011 but expect to see fewer overall fireworks.

We think that the Dollar is likely to lose a portion of the flight-to-quality capital inflows from the ongoing Euro zone debt situation but possibly regain some of its macroeconomic respect. Later in 2011, the Dollar might begin to see the benefit of the Fed's quantitative easing measures if the economy does indeed show some significant improvement, and that could mean the Dollar puts in a low during the first half of the year that ends up being an excellent entry opportunity for the long side.

Given the world's unsatisfied appetite for physical commodities and the fact that Canada and Australia were able to keep their fiscal and monetary houses in order throughout the financial crisis, it would appear that the rallies in the classic "commodity" currencies will extend even further. Currencies like the Canadian Dollar, Australian Dollar and the Brazilian Real look to gain value from a declining Chinese Yuan as well as from what could become a significant loss of value in the Japanese Yen. Having relatively strong economies this early in a global recovery will help these currencies attract capital from around the globe, especially if a series of rate hikes serve to boost the interest rate differentials.

Forex *continued*

The outlook for the Euro during 2011 will depend largely on how the EU deals with their problems with sovereign debt. While core EU nations such as Germany and France appear to have recovered enough that their inflation levels could become an issue, the question of whether nations such as Ireland and Portugal can improve their fiscal condition may prove to be the key factor that determines the Euro's direction this year.



With UK longer-term interest rates already holding a yield advantage over most of major economies, the British Pound is likely to maintain relatively strong during the early portion of 2011.

The Swiss Franc finished last year by posting record highs but may need to see further global risk concerns in order to extend prices any further to the upside. If the worldwide recovery continues to gain momentum and the need for a historic flight to quality premium is reduced, the Japanese Yen could end up coming under sustained pressure during 2011. With Japanese export firms and the Japanese government looking for much lower Yen values, it wouldn't be a stretch to suggest that the Yen could become the "biggest loser" in 2011.

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