Sugar: The Sweet Smell Of Excess

Sugar surely is the only word in English wherein a leading 'Su' is pronounced 'Sh.'

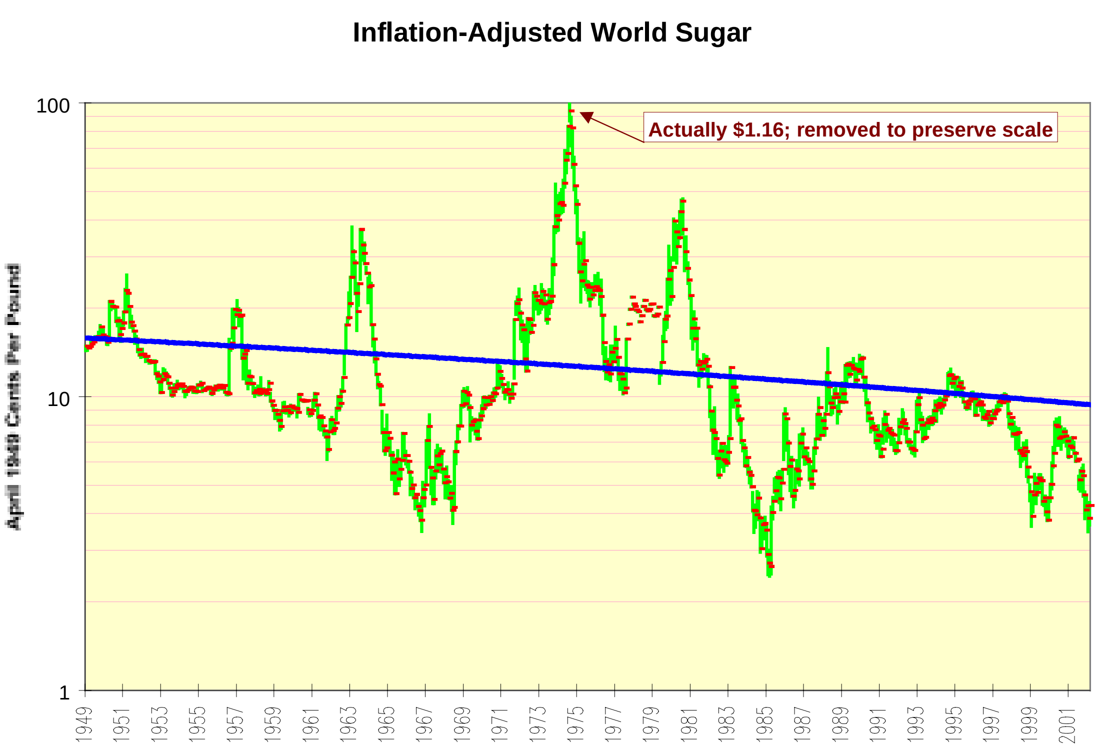
As a commodity, the Other White Powder is plagued by the same problems of excess production capacity, slack demand growth and lack of pricing power that plague many manufacturers. As a result, prices are moving back down toward the 1999 lows.

Well, as my bearish friends might say, where there's pain and suffering, there's opportunity. When life hands you a lemon, make (sweetened) lemonade. Since confectioners, food processors and soft drink syrup producers are major consumers of sugar, let's see if candy is dandy.

The Original Packet Data Network
Just how badly the sugar market has been taking its lumps? Since April 1949, when the world's population was less than half of today's level, real sugar prices have fallen by more than 71%, and presently stand at levels not seen since 1985. While there's no Moore's Law involving sugar production, such declining prices are to be expected. If prices rose, substitution by artificial sweeteners and high-fructose corn syrup would accelerate.

Moreover, much of the world's sugar production is subsidized, as is cane sugar in Florida and Louisiana, or beet sugar throughout much of Europe. The New York Board of Trade has two sugar contracts, an active one for world sugar, and a relatively inactive one for the domestic sugar that's more than three and one-half times as expensive. Who pays for these higher domestic sugar prices? You do.

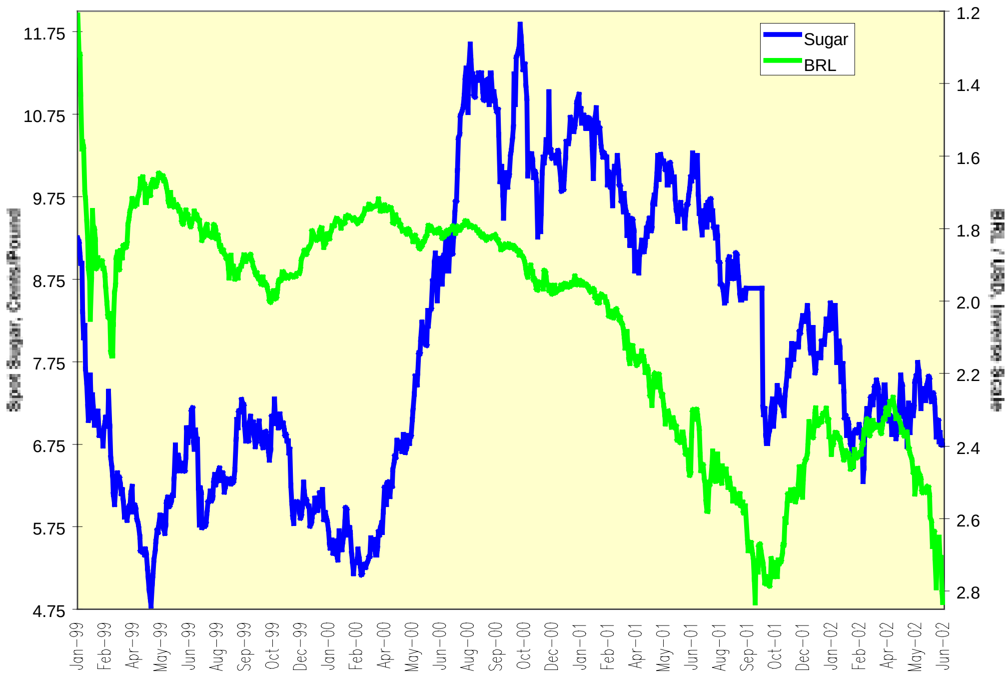
State marketing boards whose goal is to generate foreign exchange earnings, not to maximize profits, dominate world sugar production. Indeed, the latest Latin American currency/debt crisis, in Brazil, (we should start assigning these ongoing belly flops names, much as we do for hurricanes) will pressure Brazil to expand exports regardless of the effect on price.



The Brazilian Connection
The Brazilian Bovespa index has been taking it on the chin this year, down 23.4% in Brazilian real (BRL) terms and a whopping 37.5% in U.S. dollar terms. The yield on long-term bonds has surged to 22.3% from 14% at the end of

April. Over the same period, the BRL has fallen to 2.83 to the dollar from 2.36. The Argentine default and the prospect of a an incoming socialist administration later this year have combined with the realization that the IMF cavalry won't be able to ride to the rescue this time has led to the carnage.

The Real Thing



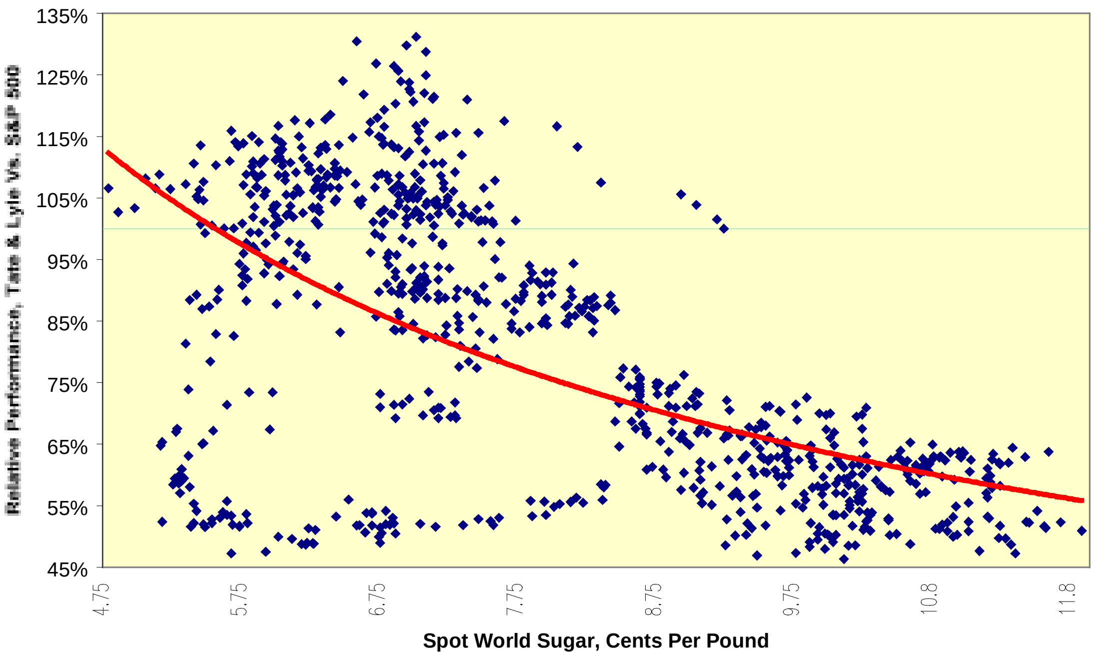
The end of controlled devaluation in Brazil in January 1999, an event which in retrospect ended the cycle of global financial crises dating from the Thai baht devaluation in July 1997, was followed in very rapid order by a big plunge in world sugar prices. A less abrupt BRL drop in early 2001 pushed the sugar market over the edge one more time. The current BRL washout is threatening to do the same, so let's find a likely beneficiary.

Make A Pile On Tate & Lyle

Falling commodity prices generally benefit the buyers of raw materials who can then add value via distribution. The ADRs of Tate & Lyle PLC, the British sugar refiner, have a one-year total return of 44%, including a 9.5% gain so far in 2002. You've got to like its 7.34% dividend yield, too, now that dividends are all the rage once again.

Tate & Lyle's relative performance to the S&P 500 has had a strong sugar price component to it since the January 1999 BRL devaluation. It outperforms the broad market when sugar prices fall, and underperforms when sugar prices rise. This is a perfect profile for a commodity consumer: Any buyer of any commodity wants its performance to look like a put option on that commodity. A put option benefits from lower prices and has a limited loss at higher prices. So, a buyer of Tate & Lyle could hedge their position by selling put options on sugar.

A Do-It-Yourself Put Option On Sugar



Trade Is Aid

Tate & Lyle is one of the few relatively pure plays on sugar from either the production or consumption sides. Coca-Cola may be a huge consumer of sugar globally, but it switched to high-fructose corn syrup in its U.S. operations years ago. Mars Inc., is a privately held powerhouse in the confection business, so we are unable to judge its performance, but other major confectioners such as Hershey Foods and Tootsie Roll Industries have had a difficult time in 2002. These American firms are subject to the domestic, not world, price of sugar, and therefore are unable to benefit from lower feedstock costs.

Why American consumers should pay 3.5 times the world price to benefit a few sugar growers is unclear. It is the same loser's game of protectionism that has caused steel prices to shoot higher and damage the American auto industry. Have you checked auto sales and the price of General Motors lately?

If we want to help Brazil and other sugar producers out of their morass – this time – let's forget about one more cockamamie IMF sweep-it-under-the-rug scheme and buy sugar cheaper from them than we can produce it for ourselves. It's a win-win solution for a but a handful of American sugar growers.