A Day Without Sunshine

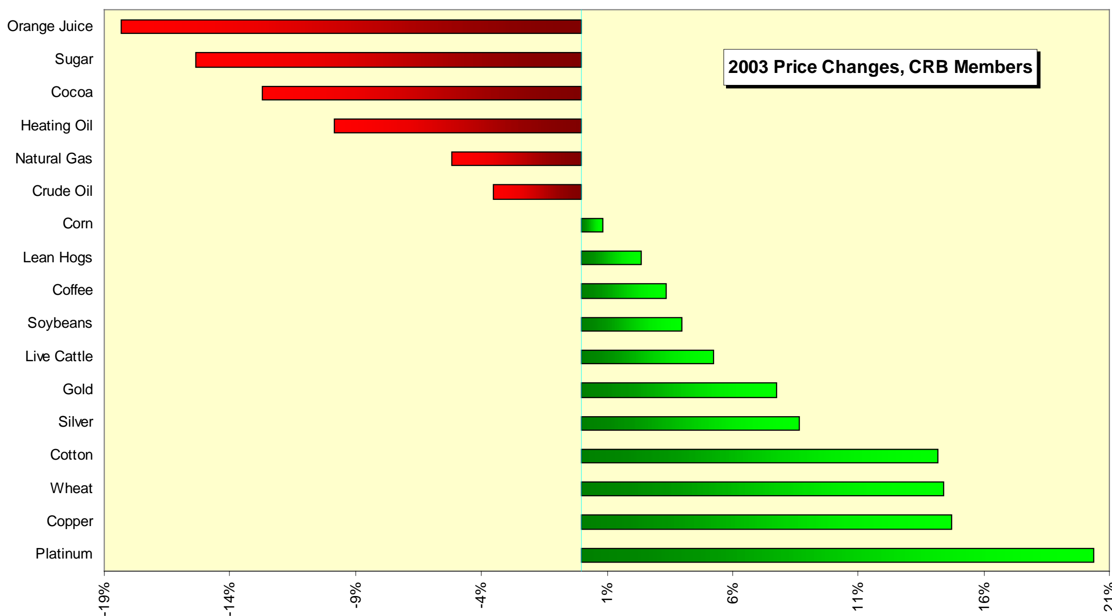
The Labor Day holiday is a convenient demarcation for the end of summer. The world of physical commodities has been busying itself for this event for quite sometime now, as it must. Financial assets can be created nearly instantaneously, but physical commodities, especially agricultural ones, take time to create.

Fuels such as natural gas and heating oil jump to mind at first mention of winter. Orange juice, including the frozen concentrate (FCOJ) that serves as the basis of the futures contract, used to be a great winter trading play. It was a weather derivative before anyone even knew what a weather derivative was, a pure and simple play on whether a cold front would punch into Florida and keep temperatures low enough long enough to kill trees.

To some extent, all of this was a cheap vicarious thrill, which may be why the 1983 comedy classic *Trading Places* was centered on orange juice futures. Many of the orange groves were owned as tax shelters by investors who deliberately were seeking operating losses, and the actual damage to the economy as a whole was limited. After all, if we lose crude oil supplies or if the corn crop fails, we have a problem. If orange juice goes up in price, finding something else to drink should not be too difficult.

Low-Hanging Fruit

While commodity prices in general feel as if they have risen strongly this year, the CRB and Goldman Sachs indices are up only 3.6% and 2.8%, respectively. And while the energy commodities, the ones most visible to us in our roles as consumers, feel as if they have risen the most, they actually have declined in price since the end of 2002 as measured by the continuous front-month futures contract. Industrial metals, including platinum and copper, have been the strongest performers, while FCOJ has been the weakest of the seventeen CRB constituents.

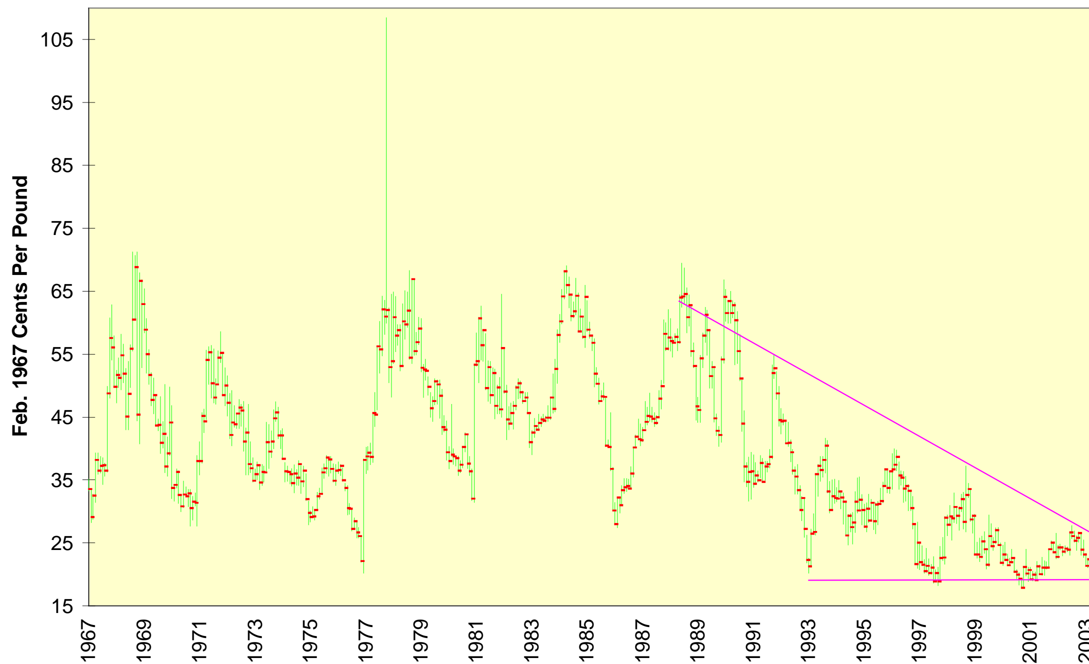


Blame It On Rio

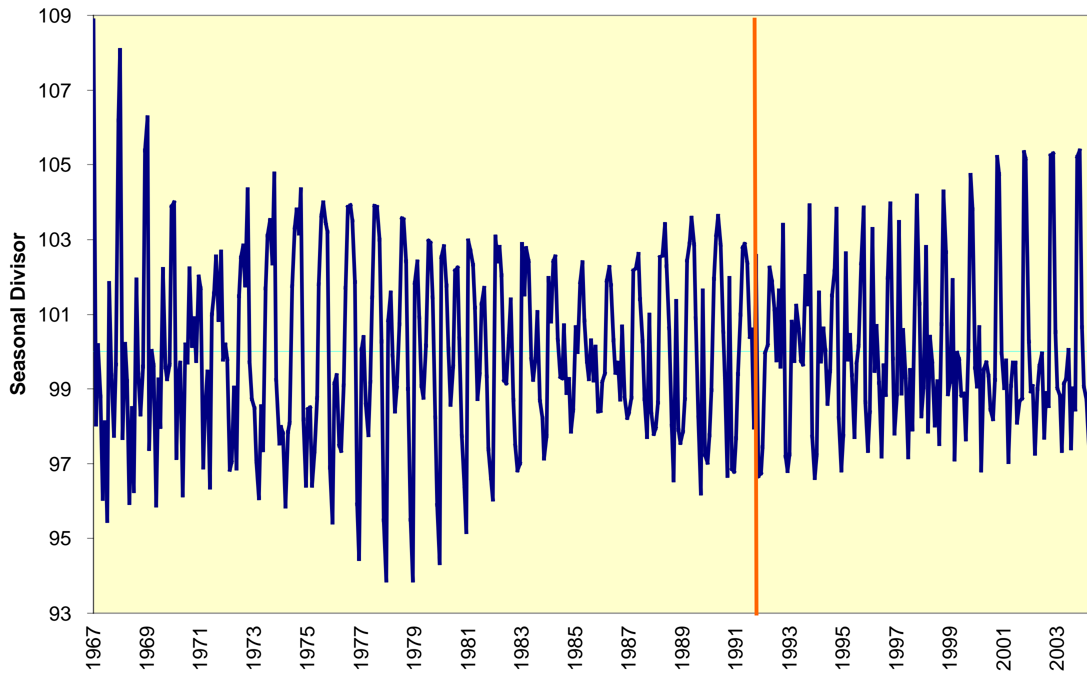
The seeds of a weak FCOJ market were planted during the Nixon administration. The 1973 decision to embargo soybean exports to Japan in an attempt to hold food prices down in the United States was as much of a shock to Tokyo as was the later Arab oil embargo. While much of the U.S. soybean crop goes to livestock feed and very little is consumed directly, soybeans represent a major direct source of protein in the Japanese diet. The Japanese responded by creating and funding a large soybean industry in Brazil.

The large tracts of open freeze-proof land in Brazil were suitable for citrus groves as well, and by the late 1980s, Florida growers found themselves faced with a low-cost high-volume exporter of orange juice. Inflation-adjusted FCOJ prices have been getting squeezed lower for the past 15 years; worse, they have not seen any of the major freeze-related spikes that characterized the market in the late 1970s and early 1980s. Not only have there been

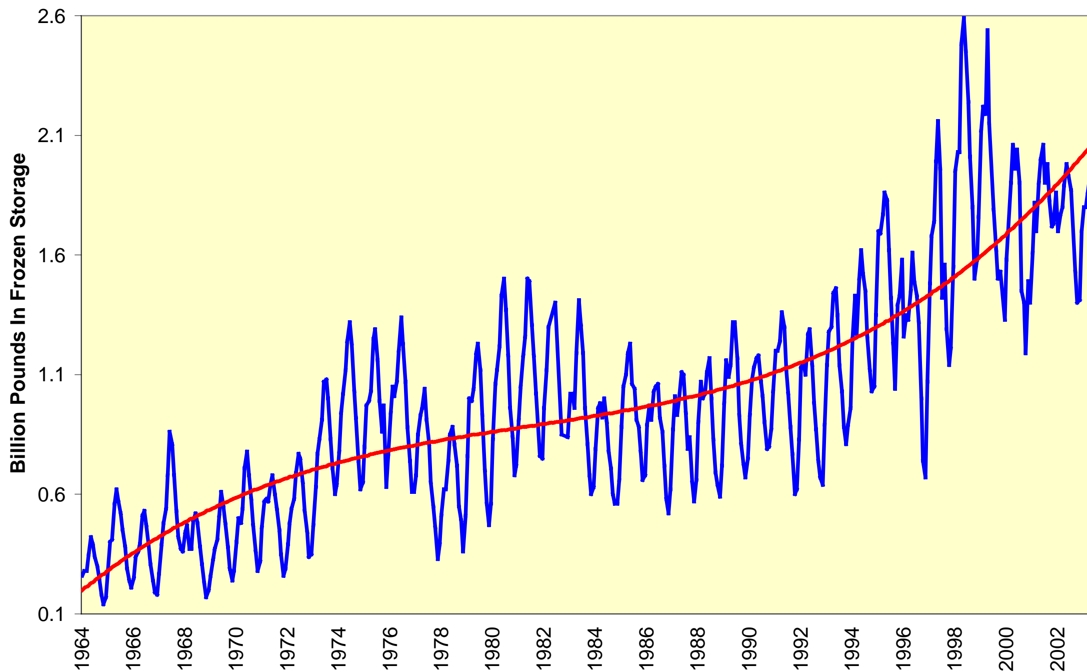
fewer freezes, but the experiences of that era and the urban sprawl through the Interstate 4 corridor between Tampa and Orlando encouraged Florida growers to replant further south.



The increasing dominance of Brazilian exports changed the seasonal structure of the FCOJ market. If we run FCOJ prices through the Census' X-11 seasonal adjustment program to extract the seasonal adjustment factors, we can observe a change in the winter of 1991-1992. Prior to this point, seasonal highs tended to occur during the summer, well after the harvest of the Florida crop, and seasonal lows tended to occur in the early autumn, when the size of the impending crop became better known. After this point, the highs shifted to November and December in speculative anticipation of a freeze, and the lows shifted to the spring in anticipation of the Brazilian crop.



These seasonal highs do not last very long, nor should they. The simple fact is FCOJ supplies in storage have been increasing far faster than the population for four decades, and there is no evidence whatsoever of an income elasticity of demand (is someone going to celebrate a promotion with a well-deserved tumbler of Minute Maid or Tropicana?). Moreover, demand patterns have shifted from FCOJ to fresh - not from concentrate, in industry parlance - juice.



If You Can Drink It, Don't Trade It

Physical commodities are tough to trade when they are in a grinding bear market. Suppliers tend to cut output to slow the descent, and they are faced with an almost non-existent price elasticity of demand: You are not going to start guzzling orange juice just because the price is lower. Moreover, suppliers often control the news as well, and it's always interesting to see the inverse relationship between price and tales of supply disruption.

Right now, FCOJ futures look as if they are going to descend to the 65-cent level seen in the summer of 1993 and later in the fall of 1997. That would be a gain of 13 cents, or $1,950 per 15,000-pound contract, if reached. If such a level is not breached by early November, a fling to the long side might be interesting, but quickness is the key. Once the price spikes, the Brazilian exporters will sell into it, and they have a lot more oranges than you do.

FCOJ highlights, once again, why commodities are so different from stocks. You can push a stock to completely unrealistic levels with a good story, and people actually line up to buy more of it. If you do that to a commodity, demand falls and supply comes out of the woodwork. But, commodities are regarded as rank speculation, while people put their life savings and retirement funds into stocks. Makes sense, doesn't it?