

# The Keystone Report

January 26, 2003

*Maximize Profits by Managing Market Risks*

## Threat of War Boosting Commodity Indexes U.S. Economy - Dollar in Decline

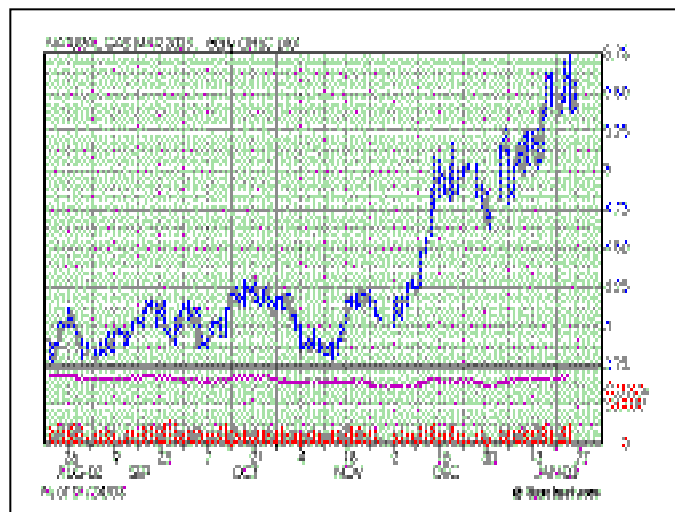
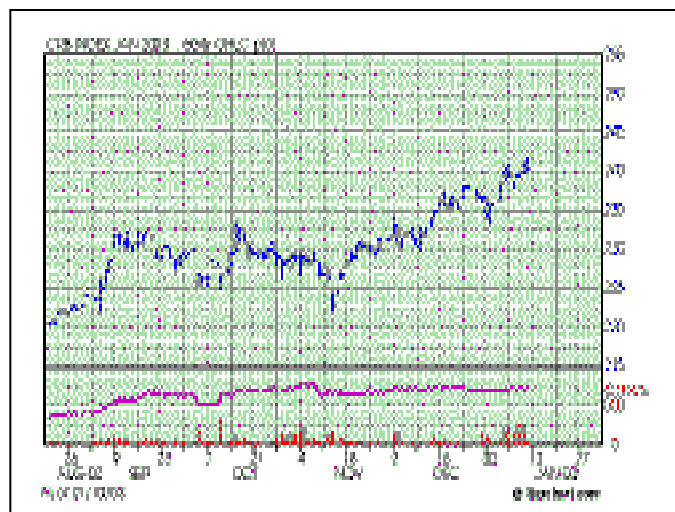
As the U.S. draws closer to conflict with Iraq the impact upon commodity prices is following a typical historical pattern. Global conflicts provide the impetus for rising commodity prices and the current scenario is playing out in that fashion

CRB Futures Price Index 1967=100 - Jan 23, 2003					
	Today	Previous	Change	Year Ago	Change
CRB Futures Index	243.47	243.49	-0.02	189.33	54.14
Industrials	185.66			151.02	34.64
Grains	186.07			163.52	22.55
Livestock & Meats					
Energy	249.21			248.29	0.92
Precious Metals	339.84			189.88	149.96
Softs	298.67			236.80	61.87
	328.44			254.17	74.27
CRB Total Return Index 1982=100 - Jan 23, 2003					
CRB Total Return Index	207.63			166.86	40.77
CRB Futures Price Indices 1977=100 - Jan 23, 2003					
Currencies	126.48			109.64	16.84
Energy	278.86			181.40	97.46
Interest Rates	115.84			109.46	6.38
CRB Spot Indices 1967=100 - Jan 23, 2003					
Metals	202.33	202.40	-0.07	174.38	27.95
Textiles	231.56	230.60	0.96	217.06	14.50
Raw Industrials					
Foodstuffs	256.96	256.40	0.56	219.23	37.73
Fats & Oils	238.83	237.23	1.60	201.89	36.94
Livestock	218.25	218.05	0.20	166.41	51.84
CRB Spot Index	315.66	313.72	1.94	252.43	63.23
	249.46	248.46	1.00	212.03	37.43

The CRB Futures Price index has advanced by over 54% from one year ago with the largest net gains accruing to the energy sector. Crude-oil futures reached a two-year high as concerns about war in Iraq were heightened by the discovery of chemical warheads by United Nations inspectors.

Nymex's March 2003 crude oil contract hit a new contract high during the week trading above \$35 a barrel. Nymex natural gas futures rallied to a

22-month high after a higher-than-expected draw down in inventories and forecasters calling for cold weather to extend into next month. The February contract touched \$5.70 per million British thermal units in Thursday's trade.

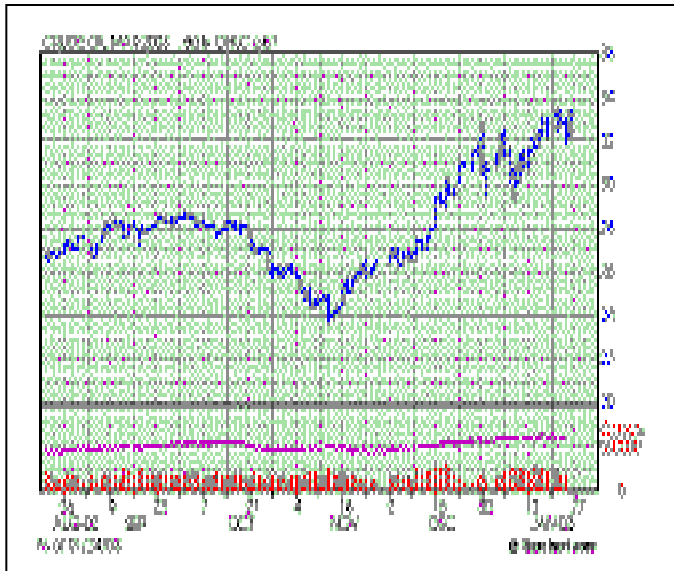


There are no plans at present for an emergency meeting of Organization of Petroleum Exporting Countries members, and there are no new proposals

The Keystone Report is published by Keystone Marketing Services, Box 541, White City, Saskatchewan S0G 5B0. Telephone (306) 789-4164 Fax (306) 781-1027 Web [www.keystonetrading.com](http://www.keystonetrading.com) Annual subscription rate \$125.00 + GST. Market Alert Automated update \$225.00 + GST Canadian Funds.

Information contained herein is gathered from sources believed to be reliable, but cannot be guaranteed as to accuracy or completeness. Keystone Marketing Services assumes no liability for any reliance on or use of the information and opinions contained herein. No part of this publication may be copied or reproduced without permission of the editors.

on the table regarding output increases to check the rapidly rising energy costs.



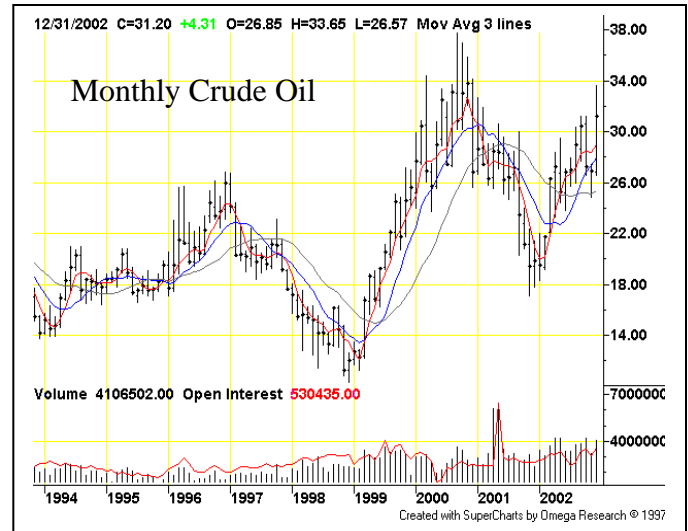
OPEC's next official meeting is slated for March 11 in Vienna. At an emergency meeting on January 12, OPEC members said they would increase oil supplies by 1.5 million barrels a day from February 1 2003 to make up for a drop in Venezuela's production caused by a crippling strike which is in its eighth week. President Hugo Chavez's latest effort to return the country to normalcy involves large-scale military moves against major corporations, which has drawn concerns in international business and political circles.

Imports from Venezuela account for about 1 of every 10 barrels processed in U.S. refineries in recent months, with commercial crude oil stocks at their lowest levels since 1975, at just over 270 million barrels.

If crude oil inventories fall further, analysts at the U.S. government's Energy Information Administration warn that the industry will be forced to curtail crude oil inputs into refineries. If this happens, refinery output would also fall and product inventories would need to be drawn down to supply demand.

The trade is now focused on the challenge for OPEC to make up for the combined loss of some 2

million barrels per day of Venezuelan crude exports and a potential loss of Iraq's flow of an estimated 2.3 million to 2.5 million barrels per day. Oil markets have shown that short-term supply concerns have overtaken OPEC promises, with prices climbing by 10%, or nearly \$3/barrel, in the seven trading days since the Organization of Petroleum Exporting Countries January 12 meeting committed to a rise in quotas to hold down prices.



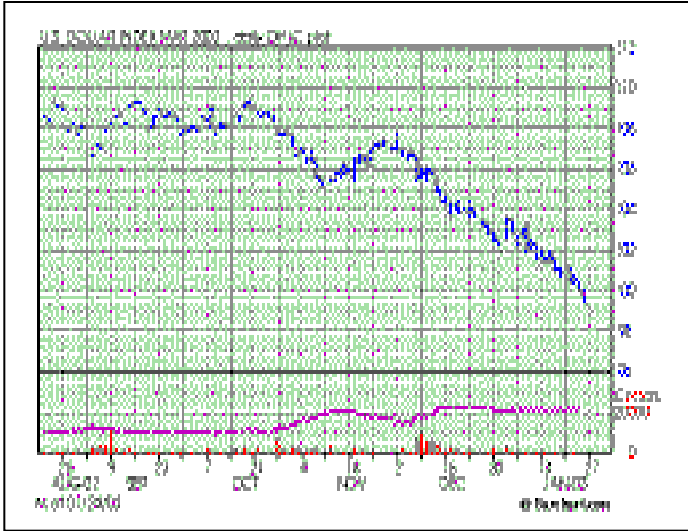
Seasonally during the month of February energy prices typically peak, with high-season winter demand already covered. In the current year the volatile international situation coupled with the recent cold weather looks to extend the bull market further. Crude oil prices are now on target to challenge the previous long-term highs at \$38.00/barrel on the above long-term monthly oil chart.

President Bush, as his father did in January 1991, is expected to order an opening of the government held Strategic Petroleum Reserve (SPR) to quash a price spike with the start of military strikes on Iraq which are widely expected during the month of February. The U.S. SPR contains an estimated 600 million barrels of crude , and similar holdings among other industrialized nations are the last resort to keep oil prices in check. In 1991, crude futures plunged by over \$10 a barrel in the biggest one-day sell off ever on the Nymex following the announcement of the opening of the SPR. We will look for heightened volatility in the energy market

in the upcoming month with a blow off top likely to occur as in 1991.

## Foreign Currencies

The threat of impending war has also had major implications for the currency and equity markets. The U.S. dollar made new lows this week dropping below the psychological “ 100 index level” on Friday’s trading session.



Investor’s lack of confidence in the U.S. currency was further weakened after reports on Friday indicated a dismal U.S. December payroll report, which signaled, continued weak consumer demand. Job losses in the U.S. soared to 101,000, greatly exceeding pre-report forecasts for a modest increase of 20,000. As a result the U.S. dollar hit a fresh three-year trough against the Euro, while sliding to its weakest point against the Swiss franc in four years.



As the central figure in financial markets, the U.S. dollar is faced with multiple threats to global stability that is breaking out on several fronts. As well as the conflict with Iraq, North Korea’s decision to escalate the crisis by admitting to having a secret nuclear program in violation of a 1994 agreement has upped the anti. North Korea is believed to have produced two nuclear weapons already and experts say its complex at Yongbyon could produce several more within months. Although North Korea says it has no such intention, it has withdrawn from a global nuclear non-proliferation treaty.

The U.S. and its allies suspended oil shipments to the North, and Pyongyang responded by expelling UN inspectors and preparing to restart a 5-megawatt nuclear reactor to generate badly needed electricity. North Korea says it would consider UN sanctions an act of war.

The implications for a wider and more lengthy global conflict are negative for the U.S. currency. Investors in U.S. assets, while aware of war risk, appear in recent months to have priced in an overly optimistic scenario under which the war on terrorism has already been won, the war against Iraq has already been priced in, and a war on the Korean peninsula is too remote a possibility to take seriously.

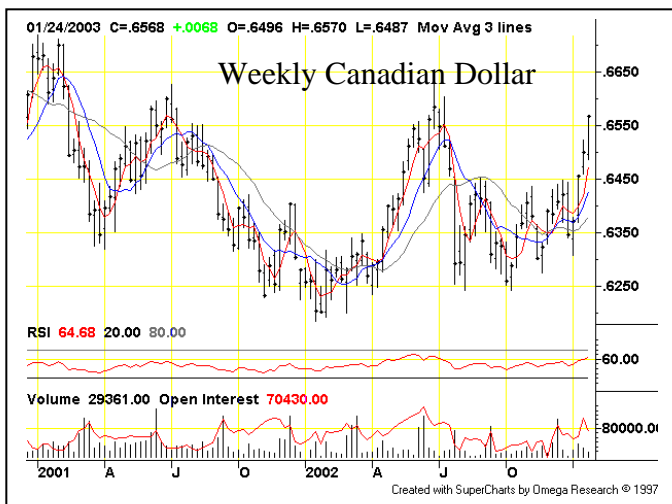
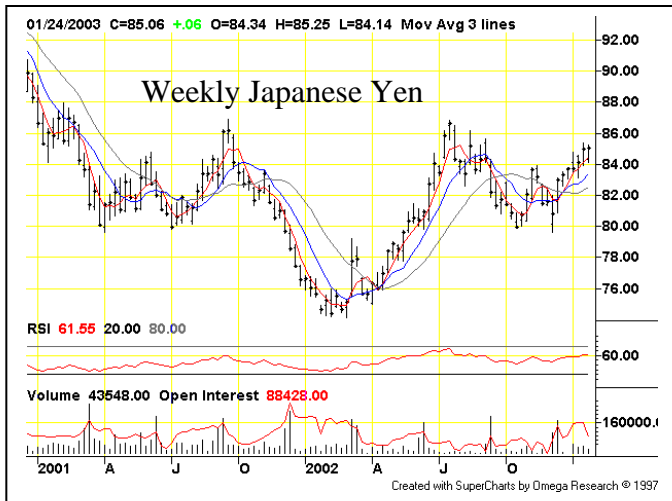
Should this optimistic scenario prove to be misguided, global capital flows will be impacted much more severely which would be bearish for the U.S. dollar, given the US’s status as a creditor nation dependent on foreign investment inflows to finance its large current account deficit.

The strength of the U.S. dollar has been sustained by the net export of U.S. capital assets -- the purchase by foreigners of stocks, bonds, real estate, or whole companies in the form of multi million dollar acquisitions. Commodities have suffered during this economic cycle, as the strong U.S. dollar in which most international transactions are

conducted, made foreign purchases of U.S. produced commodities such as grains and oilseeds more expensive.

The Euro, which is the sole currency of the 12 nations in the European Monetary Union -- including Germany and France, but not including Britain has increased from a low of 86 cents in January to parity with the dollar by July, closing at new highs during this week's trading.

The Japanese yen and Canadian dollar which are dependent upon low foreign exchange rates to make their exports more competitive have also shown signs of having made significant bottoms vis a vis the U.S. dollar in January of 2002.



A major beneficiary of the volatility in foreign currencies has been the gold market. The increased anxiety of war has sparked heightened interest in

gold, boosting the price of this traditional safe haven asset to the \$370 per oz price level on Friday's trading session, a level not seen since late 1996.



Investor sentiment toward gold started improving in September 1999 when 15 European central banks signed the Washington Agreement, pledging to limit their collective annual gold sales to 400 metric tons for five years. Prior to the agreement the price of gold had declined to \$250/oz with many large producers actively hedging forward sales and central banks actively reducing their gold reserves. The prevailing sentiment was that gold as a strategic investment held no appeal in light of the double digit returns accruing to the equities markets and the rising value of the U.S. currency.



With the low gold prices rationalizing the industry to the lowest cost competitors and a sharp price rally in late 1999, many mining companies began rethinking their hedging practices, which in turn helped to further tighten supply.

Last week, London-based commodity research firm Gold Fields Mineral Services reported that the global hedgebook in 2002 contracted by a "substantial" 352 tons.

The February 13, 2002 *Keystone Report* highlighted the response of the gold and silver markets to the renewed concerns over the health of the global economy.

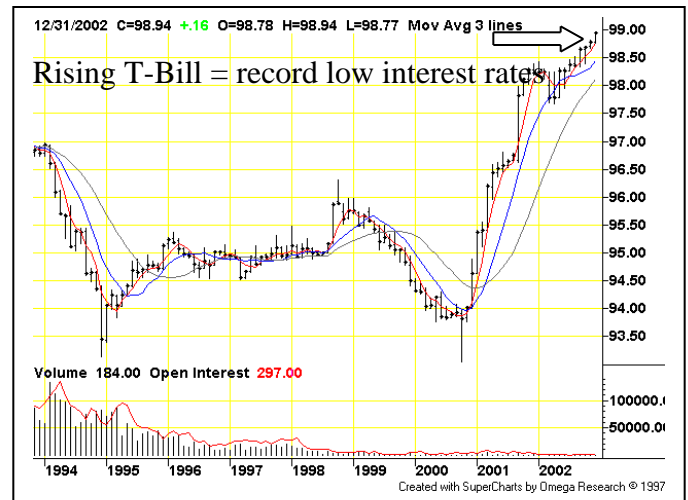
“Financial scandals surrounding the energy giant Enron Corporation, and renewed interest by Japanese investors concerned by impending limits that the government was to impose on guarantees for time deposits in Japanese banks, have sparked a rally above the psychological \$300 per oz price level”. “The question now becomes whether the trend to higher precious metals prices is based upon commercial demand or whether the market is becoming much more influenced by investment and financial security concerns. With the continued pressure on global equity markets and poor returns on cash and bond markets, the rush to gold has the potential to become a much greater market force in the weeks to come”.

“The US dollar index remains king of the currency markets. While remaining in an overall uptrend, it is showing signs of tiring, with the 120.00 price level providing a strong level of overhead price resistance. With an ever-increasing number of countries devaluing their currencies in an attempt to insulate their economies from the required economic adjustments, the American economy will be faced with continued and growing problems with trade deficits. The US will be the most attractive market to sell goods and services, while its ability to export will be severely hampered by the strength of the dollar.”

“This strong dollar policy has extended the depth and severity of the deflation in commodity prices,

which will rebound when a fundamental realignment in the foreign exchange markets is completed. We will be alert for US economic policy changes that will establish an historic high in the US currency as well as the inflationary potential that is set to explode following the completion of these fundamental economic adjustments.”

Since that date the major fundamentals of declining equity markets, a lower U.S. dollar and a strengthening of international commodity prices have continued to gather momentum.



Interest rates on short-term Treasury bills fell in this Tuesday's auction with the rate on three-month bills dropping to the lowest level since the summer of 1958. The three-month rate was down from 1.180 percent last week and was the lowest since three-month bills averaged 0.984 percent on July 28, 1958. The six-month rate was down from 1.230 percent last week and was the lowest rate on record.

Historically, low interest rates combined with rising energy costs and a growing U.S. deficit suggest a fundamental restructuring of the economy is all but necessary with inflationary consequences. On February 4 2003 President Bush will release his budget proposal for 2004. Analysts anticipate it will show a deficit of \$300 billion or more. That would be the largest deficit in U.S. history, surpassing the \$290 billion reached in Bush's father's administration in 1992. As a percentage of the \$10 trillion national economy, however, it would be less than in the 1980s and early 1990s.

The turnaround from earlier hype of trillions of dollars in surpluses has been rapid.

In 2001, when President Bush won tax cuts of \$1.35 trillion over a decade, Congress and the White House forecast more than \$5 trillion in budget surpluses over the same period. Nearly a decade of spending restraints and tax increases during the early 1990s, combined with a bull market in the stock markets that boosted capital gains, had turned deficits to surpluses beginning in 1999.

By 2001, following the New York terrorist attacks, the surplus began falling. In 2002, the government ran a \$157 billion deficit. And by last August, the Congressional Budget Office had reduced its estimate of the surplus to a fraction of its previous forecast -- \$336 billion over 10 years.

Confidence in the U.S. economy is beginning to be seriously eroded with the rising deficit. The ability to follow through on the planned tax cuts is questionable. Tom Kahn, Democratic staff director for the House Budget Committee, says he expects the new Congressional Budget Office (CBO) forecast will show a deficit every year for the next decade. Last summer, surpluses were predicted by 2006. "The biggest fiscal switch-around in U.S. history," Kahn says. "Going from a \$5.6 trillion surplus to a \$2 trillion deficit is just mind-boggling."

The new projection does not include the cost of a potential war with Iraq, which could add tens of billions of dollars to the deficit. The cost of occupying Iraq after a war, also not in the CBO forecast, could be even larger.

Should the deficit become an increasing factor in U.S. domestic policy, the potential for inflationary forces to gain the upper hand in dealing with the looming financial burden grow stronger.

In addition to the budget deficit, the U.S. trade deficit as reflected by the current account, bulged to a record \$40.1 billion in November, reflecting Americans' ravenous appetite for foreign-made goods, especially toys, TVs and clothes. The Commerce Department reported Friday that the

imbalance between what the United States sells abroad and what it imports swelled by 13.9 percent from the October deficit of \$35.2 billion.

November's deficit was bigger than the \$36.4 billion imbalance analysts were predicting which provided further bad news for the U.S. equity markets and U.S. dollar.

The implications of a further drop in the U.S. dollar would suggest a positive impact for exports of U.S. commodities such as grains and oilseeds, which have struggled with weak demand patterns during the current marketing year. It will be imperative for the U.S. economy to reverse the tide of a growing negative trade balance and to put the brakes on a rising budget deficit.

For the week ended Jan 16.7, in thousand tonnes, except cotton in thousand running bales. Net changes in commitments are gross sales, less cancellations, buy-backs and other downward adjustments. Total commitments are total export shipments plus total sales.

The marketing year for wheat and barley began Jun 1, cotton and rice Aug 1, corn, soybeans and sorghum Sep 1, and soymeal and soyoil Oct 1.

	wk's net change in commitments		total commitments		undlvd sales	
	this year	next year	this yr	last yr	this yr	next yr
wheat	417.0	20.0	17548.7	19068.2	3306.8	60.0
corn	681.4	0.2	21155.7	23448.6	5596.3	264.7
soybeans	572.0	0.0	21931.8	22609.5	7920.9	77.0
soymeal	214.7	7.8	3617.0	4113.9	1704.1	244.5
soyoil	72.9	0.0	359.0	379.5	200.1	0.0
upland cotton	188.1	1.0	7155.3	9044.6	3621.1	494.1
pima cotton	17.9	0.0	436.0	314.6	201.0	0.8
sorghum	42.1	0.0	2791.9	3793.4	958.0	0.0
barley	21.7	0.0	389.9	549.5	80.5	0.0
rice	92.5	0.0	2353.2	1845.9	810.5	0.0

The current trend towards a lower U.S. dollar will be one of the foreign policy instruments used to accomplish this objective in order to stimulate export demand for U.S. goods and services as well as to check the growth of U.S. foreign demand.

With growing opposition by key U.S. allies toward an imminent strike on Iraq, while U.S. officials seem more firmly pointed in the direction of war, the greater is the risk aversion to the U.S. economy. The general feeling is that the more the U.S. becomes isolated, and the longer and more drawn out the upcoming conflict becomes, the more negative it will be for the U.S. dollar and U.S. dollar assets.