

The Keystone Report

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Maximize Profits by Managing Market Risks

2004 New Year Promises Increased Volatility and Heightened Interest in Commodity Markets

The year 2003 closed out in dramatic fashion following the announcement of mad cow disease in the United States on Christmas Eve.

While it has been long expected that the disease has been present in North America in more than a single Canadian isolated incident, confirmation of the disease in the U.S. will fundamentally alter the North American cattle industry.



The impact while devastating for the entire North American livestock sector will be particularly painful for Canada, due to dependency on foreign markets, particularly the United States, in order to maintain the current scale of operations.

Canada exports approximately 70% of its product to the United States, which prior to the first incidence of the disease on May 20, 2003, accounted for more

than 1.5 million cattle annually, according to the U.S. Agriculture Department. Combined cross-border sales of live animals and animal products totaled more than \$2 billion last year. Mexico is the second largest exporter of cattle to the United States, at 800,000 head last year.

With a total ban on live cattle exports and limited market access for boneless beef cuts, Canadian producers have been toughing out the situation, awaiting further progress in opening the U.S. border and a normalization of trade.

As of this writing speculation is now centered on positive identification of the source of the U.S. infected animal, which would appear to originate from Canada. Should this be confirmed the much hoped for increase in Canadian exports could be delayed even further, raising the specter for massive Canadian herd liquidation should the issue drag on through the winter into the spring.

Dr. Brian Evans, chief veterinary officer of the Canadian Food Inspection Agency, said it is premature to draw any conclusions about the cow's origins because Canadian and U.S. records that ostensibly refer to the same cow don't agree on key details. Based on the Canadian records, the diseased cow was 6 1/2 years old - older than U.S. officials had thought. Dr. Ron DeHaven, chief veterinarian for the U.S. Agriculture Department claims U.S. papers on the infected cow indicate she was 4 or 4 1/2 years old. The age is significant because the U.S. and Canada have banned feed that could be the source of infection since 1997.

Prior to the ban farmers could feed their animals meal containing tissue from other cattle

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and livestock to fatten them. Countries have banned such feed because infected tissue - such as the brain and spinal cord – are thought to be the source of the disease. Canadian officials will try to show that the sick animal was not fed the banned feed stuffs after 1997 and thus not in violation of food safety protocols at the time .

For the U.S., confirming that the sick cow came from Canada will be crucial to continue exporting beef because it could retain its disease-free status. The country has lost 90% of its exports because of the case, the National Cattlemen's Beef Association estimates, with more than two dozen foreign nations having banned the import of U.S. beef despite claims by U.S. officials that the meat is safe. Gregg Doud, an economist for the National Cattlemen's Beef Association, estimates that the U.S. stands to lose at least \$6 billion a year in exports and falling domestic cattle prices.

A U.S. delegation was to leave Saturday for Japan, which takes about one-third of all U.S. beef exports, and possibly other Asian countries that imposed bans on American beef and livestock this week.

Pinning the blame on one country or the other misses the larger point, as the long period of extensive trade between the U.S. and Canada in the beef markets has linked the two countries to the point that customers cannot distinguish between them. In the worldview, it's a North American beef market, as opposed to two separate countries.

Unlike Canada, the U.S. is dependant on only 10% of its sales in foreign markets and is the beneficiary of a declining dollar making its exports cheaper, while Canada's strengthening currency is adding another body blow to the Canadian industry.

The Canadian currency has risen more than 20 percent this year, which has impacted the economy more than the other shocks of SARS, power blackouts, drought and forest fires, including last week's case of mad cow disease in the United States and this week's news the animal might have been born in Canada.



The Canadian bank interest rate remains at a 1.75% premium to the U.S. at 2.75 percent while the equivalent federal funds rate in the United States is 1 percent. Prospects for continued strong economic growth and the potential for price inflation that gave rise to the interest rate premiums have been largely negated by this year's unusual string of negative economic events. Speculation in the money markets is that the Bank of Canada will reduce rates in its upcoming January 20, 2004 policy meeting in order to stem the rise in the Canadian currency.

The danger in this for Canadian exporters, is that the impact on the Canadian dollar will prove to be minimal, as an interest rate reduction is factored in to the loonie's current price structure, and the U.S. shows no signs of defending its currency in light of serious budget deficits.



Current price trends in North American currency markets would project the U.S. currency to reach its 1992 lows of 80, on the above-illustrated long-term chart. The Canadian dollar projects to surpass its 80-cent near term target, with potential of a longer-term objective of 88 cents last reached in the same 1992 time frame.

Impact of Foreign Exchange Markets

The impact of a change of this magnitude will be significant for the Canadian economy. Throughout much of the past decade Canada has relied heavily on a cheap currency to remain competitive in the global economy. Adjustments will now become necessary in Canadian domestic social and economic policies to support growth and international competitiveness.

Other sectors outside of the Canadian natural resource economy could be particularly challenged, including the automobile industry, which has enjoyed the benefits of North American Free trade and the low value of the Canadian dollar for a long period of time.

As we enter 2004 the trade will closely monitor the pace and strength of the US economic recovery. Recent statistics on U.S. consumer confidence have been less than encouraging despite optimistic economic growth rates of 8.2% in the third quarter, the fastest since 1984. The consumer confidence index fell 1.2 points to 91.3 in December, as

reported by the Conference Board. The index was dragged down by nervousness about the job market. Nearly 1/3 of the consumers surveyed said jobs were hard to get, up 3 % from November 2003. The drop in confidence calls into question predictions that the job market was improving strongly.

A sustained economic upturn has been long awaited since the bursting of a stock market bubble in 2000 triggered the end of the longest economic expansion in U.S. history. The decade-long expansion ended in March 2001; with the decline deepening with the September 11, 2001 terrorist attacks and war in Iraq.

Most economic forecasters believe the Federal Reserve will keep interest rates low well into the New Year in an attempt to bolster business and consumer confidence in the face of low inflation and a presidential election in November 2004.

With the Mad Cow outbreak in the U.S. just beginning and the potential for a prolonged military commitment in Iraq, the potential for the U.S. economy to lose momentum in 2004 is becoming more worrisome. The risks will be small as long as foreigners provide the capital the U.S. needs to make up for its lack of national savings - \$1.5 billion a day and growing. This raises the specter for a sudden end to the current low inflation environment and a sharp spike in interest rates.

With commodity prices trading significantly above last year's levels, the commitment of the U.S. government to policies encouraging economic growth would appear extremely friendly towards natural resource prices similar to that which was encountered during the 1970s.

CRB Futures Price Index 1967=100 - Dec 31, 2003					
	Today	Previous	Change	Year Ago	Change
CRB Futures Index	255.29	255.77	-0.48	234.52	20.77
Industrials	256.64	255.17	1.47	176.61	80.03
Grains	225.75	221.33	4.42	188.23	37.52
Livestock	237.77	241.57	-3.80	250.97	-13.20
Energy	358.74	365.64	-6.90	320.67	38.07
Precious					
Metals	364.08	365.06	-0.98	289.09	74.99
Softs	250.46	250.84	-0.38	303.69	-53.23
CRB Total Return Index 1982=100 - Dec 31, 2003	222.14	222.58	-0.44	199.55	22.59



2004:China Commodity Demand To Rise Amid Growing Economy & Increased Productivity

In addition to the global realignment of currencies and U.S. budgetary deficits, commodity markets are enjoying the impact, which accelerated demand, particularly in China, is having on natural resource prices. A nation of 1.3 billion people and still counting, China with its booming economy will become a global magnet for commodities consumption in 2004.

China's emergence as an economic powerhouse is closely linked to the progressive removal of trade barriers and "creative destruction" of jobs in western economies, to countries that can do the work more productively.

The latest figures show Canadian imports from China have more than doubled over a five-year span - to \$16 billion in 2002 from \$7.7 billion in 1998. At the same time, Canadian exports to China grew to \$4.13 billion from \$2.5 billion. Putting those numbers into perspective, Canadian exports to the United States, Canada's biggest trading partner by far, rose to \$345.4 billion from \$270 billion in that five-year period while Canadian imports from the U.S. rose to \$218.3 billion from \$203.6 billion.

The implication for further trade growth with China are enormous, particularly in the natural resource sector, as Chinese standards of living continue to increase and the appetite for natural resources to feed a growing consumer economy multiply.

The beginnings of the Chinese importance in the world economy can be traced to the rule of Deng Xiaoping (the late Chinese leader), who more than 10 years ago, said that "it was positive to make money - that profits were a good thing". From that point forward the system of Chinese state-owned enterprises began to be dismantled. Chinese exports have grown rapidly, with consumer oriented societies such as the United States and Canada providing a ready market for manufactured products at increasingly competitive values.

While North American manufacturers struggle to retain their competitive position, the potential for longer term gains due to the huge market China affords North American producers for natural resources and advanced technology, gives rise to the prospect that China may soon buy from the world more than it sells, creating a trade deficit. In addition the desire to improve its economic well being has increased the presence of foreign multinationals operating from platforms in China, which includes Canadian firms.

"Wal-Mart Global Procurement." employs more than 300 agents in Shenzhen, China to buy Chinese goods in large quantities, and negotiate the best prices for bulk orders, and then ships the goods to North American markets to be sold at attractive consumer prices. Last year, Wal-Mart acquired \$12 billion in goods from mainland China and sold them to American consumers, accounting for 10% of the \$125.2 billion in Chinese imports onto U.S. shores, which contributed to the biggest merchandise trade gap between any two nations in history.

Economists expect China's full-year 2003 exports to the United States to equal about \$150 billion. With U.S. exports to China expected at about \$27 billion, that would raise the U.S.-China deficit to a new record of roughly \$125 billion. Among the main categories of goods from China are toys, electronics

and shoes. Wal-Mart became the world's biggest corporation ranked by sales - ahead of No. 2 General Motors and No. 3 Exxon Mobil - in large part because America leads the world in bulk consumption. According to the Paris-based Organization for Economic Co-operation and Development, a global economics think-tank, personal consumption drives 70% of the U.S. economic engine, an unparalleled proportion among the world's major economies. That's more than Germany (57%), Japan (56%) or Britain (63%), the organization's figures show. Conversely, factory output - production of manufactured goods - accounts for less than in any of these countries.

The great upside to Chinese imports for the U.S. economy is the widespread availability of inexpensive, high-quality goods. On the North American side of the equation the opportunity lies in supplying high quality natural resources and technical services that cannot be readily supplied by the Chinese, such as education and health care, prices which have risen over the past decade, while the costs of made-in-China imports have plunged.

From October 1993 to October 2003, the cost of college tuition and fees in the consumer price basket rose 75%, according to the U.S. Department of Labor's Bureau of Labor Statistics. The average price tag on toys fell 30%. Cable television service fees rose 55%. The cost of television sets fell 53%. Dental services leaped 55%. Jewelry prices declined 14%. Prescription drugs and medical supplies rose 47%. Men's footwear fell 9%.

According to Andy Xie, a Hong Kong-based economist for the Morgan Stanley investment firm, "U.S. businesses add \$3 or \$4 in value from every \$1 of import value from China."

Former Chinese Premier Zhu Rongji described these markups in a 1999 convocation address at the Massachusetts Institute of Technology. Referring to a study he had done as a government official in 1987, he said: "The producer price for each pair of the sports footwear is 20 U.S. dollars but the retail price in the U.S. market was 120 U.S. dollars. I found that, out of the 20 U.S. dollars, only two U.S.

dollars were paid to the Chinese workers, but that two U.S. dollars could support the life of two Chinese workers." Even with the retail markups, Chinese goods consistently undercut U.S.-made goods.

Impact of the Trade Deficit on the Natural Resource Sector

With the trade deficit beginning to spiral out of control, the US has been forced to re-examine its consumption and trade practices with China and the rest of the world.

Worries that the U.S. will not attract sufficient investment flows to cover its widening current account (trade) deficit knocked 17 percent off the dollar's value against the Euro in 2003.



The Euro's recent series of all-time bests against the dollar has been fuelled by deepening concern about the US current account and budget deficits, as well as ultra-low US interest rates and fears about terrorism and the possible spread of mad cow disease in North America.

As a result the price of natural resources to overseas importers such as Europe and China, is becoming increasingly attractive with purchases made in a steadily declining U.S. currency. As long as the twin deficits of the US current account and US budget continue, in addition to historically low US interest rates, the commodity based currencies of

countries such as Canada and Australia will continue to benefit. This will give rise to strengthening demand for natural resources and the potential for significant upward price movement.

Commodities most likely to benefit

A review of the CRB index (page 3) suggests the sectors which will benefit the most in the short term include; precious metals, energies and the grain sector in that order.



Gold

Gold has started the first week of 2004 as it ended 2003 -- charging to its highest since February 1990 as the dollar crumbled against the Euro and the Yen and speculative commodity funds maintained their appetite for precious metals holding a net long combined futures and options position of 130,000 contracts as at December 22, 2003.

Gold has regained its position as a safe haven investment during periods of economic uncertainty, despite the widespread cynicism, which accompanied the runaway equity markets and strong U.S. dollar prior to September 11, 2001.

Gold rose about 20 percent in 2003 as geopolitical tensions and a sliding dollar raised its safe-haven status. A weaker dollar makes dollar-denominated gold cheaper for holders of other currencies, especially the Euro. Other developments in the underlying fundamentals of supply and demand,

which include changing producer strategies with gold miners buying back previously sold future production, and whether or not there will be a renewal of the Central Bank Gold Agreement. The agreement among leading European central banks, which limits official gold sales, will expire in September.

With continued pressure on the U.S. currency gold prices are poised set for additional gains in 2004.



Energy

Commercial crude stocks fell 3.8 million barrels to 270.7 million barrels for the week ended Dec. 26, according to the U.S. Department of Energy statistical branch, the Energy Information Administration. That surprised many analysts who forecast an average draw of only 1.5 million barrels. This places crude supplies 3% below year-ago levels and 9% below the five-year average.

Recent data from the U.S. Energy Information Administration projects that by 2015 natural gas consumption will be up more than 20 percent to 28 trillion cubic feet. During that period, production is expected to rise by just 13 percent, with the gap expected to be filled by more imports of liquefied natural gas if companies make the \$100 billion in new investment needed over the next 10 years.

Crude oil prices are on target to challenge the 2002 highs at \$40.00 per barrel.