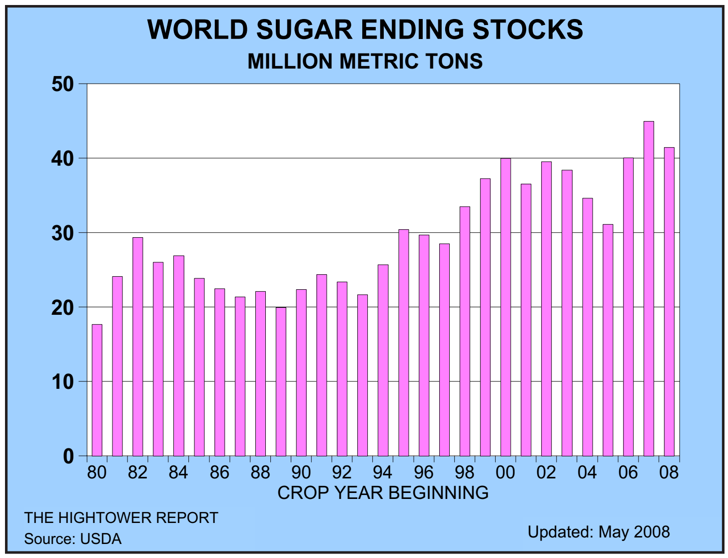
Special Report

May 28, 2008

Sugar - Probing for Major Low as Supply Peaks!



The big picture fundamentals in the sugar market are in the process of shifting from a period of excess production over the past several years to a period when world production is expected to come in 1 to 2 million tonnes below world consumption. In addition, world prices for oilseeds, feedgrain and wheat remain high enough to discourage sugar production ahead. As a result, the market could see declining sugar stocks for both the 2008/09 and the 2009/10 marketing years. With a positive tilt to the supply/demand fundamentals to start the season, factors that could increase the world deficit during the next few months include: a) weather in Europe and India, b) less planted area than expected, c) a greater than expected need for Brazil to produce ethanol which will force sugar production lower as higher percentage of cane is crushed to produce ethanol and d) global and/or China demand exceeds expectations.

Currently, record freight rates have traders concerned that Brazil sugar exports will slow, especially to Asia, and that Brazil will be stuck with increased exportable supply. In addition, there are still concerns that deliveries will be high against the July sugar contract. Two years ago, sharply higher prices encouraged production before the world ethanol trade was better established, and high prices caused a sharp rise in production from key producers such as India. This caused world production to swell well above world consumption, and the resulting sharp increase in world stocks has helped drive sugar prices to a new two-year low into June of last year. After a rally early this year, October futures have dropped 32% into the heart of the Brazil key cane harvest. Prices have a tendency to bottom when supply peaks, and world supply

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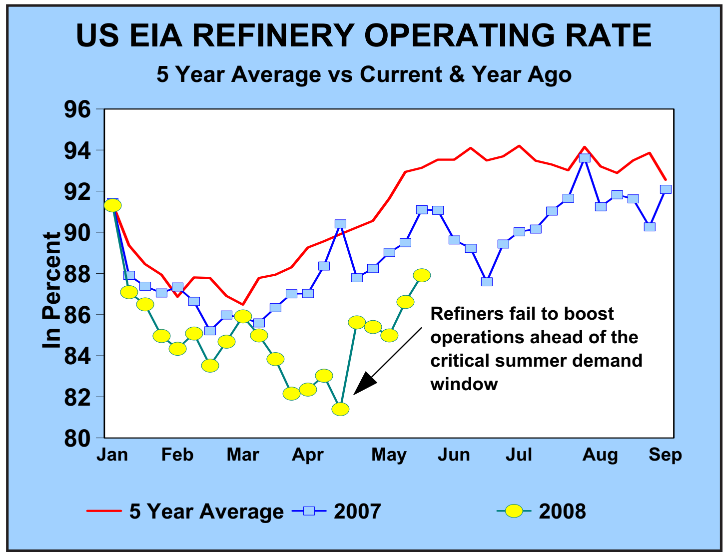
should peak into this spring. World stocks are expected to fall over the next year, and we will likely be faced with another decline for the 2009/10 season.

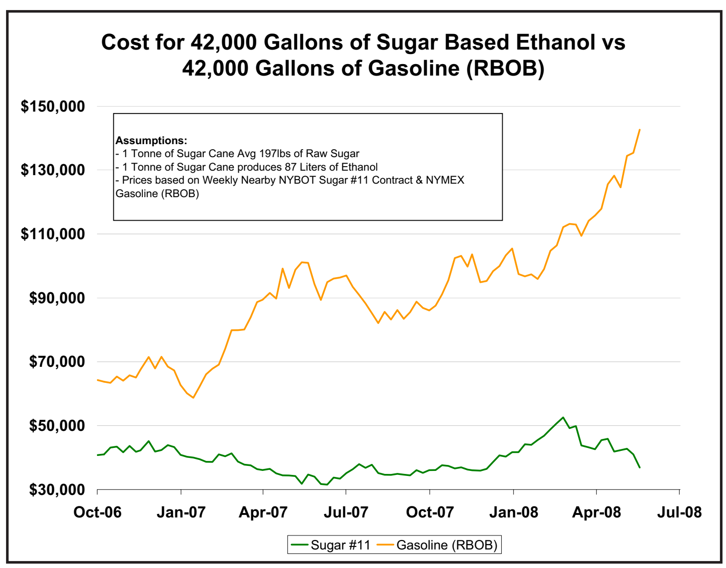
Gasoline Prices Surge

Instead of higher prices prompting increased supply flows of products like gasoline (into one of the strongest seasonal demand periods of the year), it is clear that US refiners instead decided to (or were forced to) cut back operating rates, and that action laid the groundwork for the recent explosion in gasoline prices. In looking at the enclosed chart of the US refinery operating rate, one can clearly see that the US refinery operations in early April fell to just 81.4% of capacity, which was 9% below year earlier rates. That reading was the lowest April operating rate in the last 16 years. The sharp drop in refinery operations has so far led to a steep, 26.5 million barrel decline in US gasoline stocks from peak levels seen in March. And now, only after gasoline prices have exploded, have we seen US refinery activity begin to respond. In other words, a just in time inventory method certainly seems to be contributing to higher prices, and efforts by refiners to play “catch-up” may be too little too late.



Ethanol Demand Potental

With the price of gasoline rising by over a $1.00 per gallon from its early 2008 lows and sugar-derived ethanol “feedstock” costs declining by roughly 32% from the early March highs, it is clear that the world could be using a significantly cheaper alternative fuel in the form of sugar-based alcohol.



For China, the US and other Asian countries, ethanol could be a relatively cheap source of gasoline supply. Brazil exported 288.5 million liters of ethanol in April vs. 278.8 million the previous month and 283.9 million last year. Exports could pick up in the months just ahead. The US has been an impressive importer during the spring and early summer months in years past, and it appears the need for fuel this

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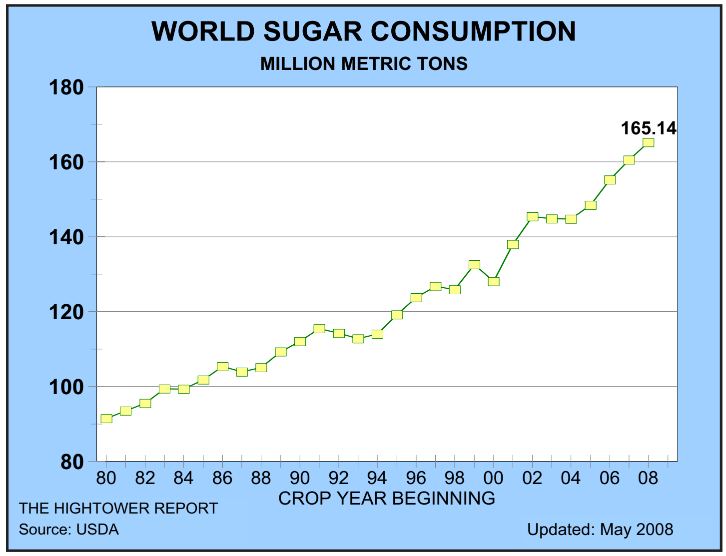
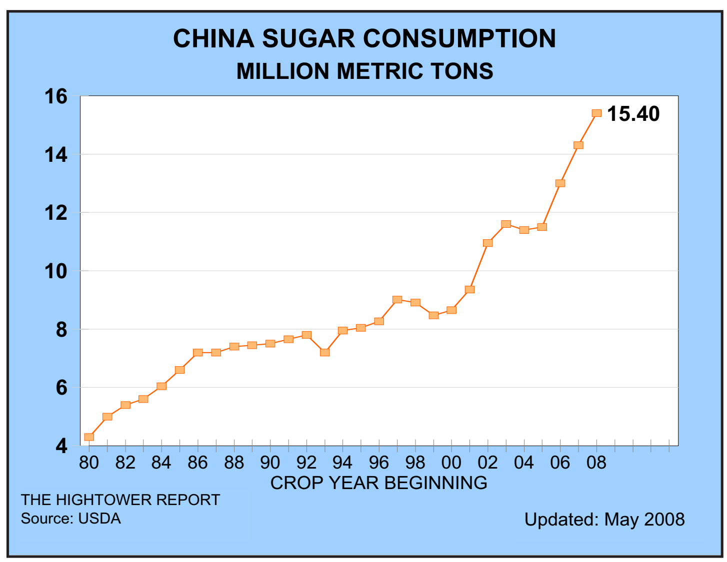
year and the incentive to import could be strong in 2008, despite the import tariff. In addition, there is talk that China is trying to increase ethanol supply around Beijing for the Olympics in an attempt to burn cleaner fuel, at least for a short period of time.



The harvest of the Brazil main center-south cane crop is now in full swing, and a larger than normal percentage of the cane crop has been shifted to ethanol production so far. With the disparity between petroleum and sugar prices, ethanol is clearly the winner. The Sugar Cane Industry Union of Brazil indicated that a record high 67% of the new crop harvest in Brazil has so far gone for producing ethanol. This compares with a more typical level of around 50% for the entire year. With so many new ethanol refineries being built there, many fields near these plants are being planted primarily for supplying them. With relatively low sugar prices and record high world gasoline prices, Brazilian sugar cane crushers may be in a position to continue to lean toward ethanol production, especially if Brazil ethanol exports pick up some steam.

Sugar Production "Deficit" Expected in 2008/09



The International Sugar Organization indicates that world production for 2008/09 may come in about 1.0-2.0 million tonnes below consumption. This would be a sharp difference from the world production surplus this season of 7.8 million tonnes. The US Foreign Agriculture Service last week issued a new sugar report in which it pegged world production for the 2008/09 season at 161.7 million tonnes, down 3.7 million tonnes from last year. World ending stocks are pegged at 41.5 million tonnes, down 3.5 million tonnes.

There is no technical sign of a low yet, but the market is oversold, and the recent Commitment of Traders report shows that the speculative net long position in sugar has declined to a more normal level. We believe the sugar market will put in a low soon. Futures traders can wait for a technical sign of a

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low, which might be seen from a weekly reversal or other signal, but option traders can position for the move ahead of time "just in case" there is a spike reversal. Look for lows for October sugar near the 11.17 to 11.02 zone, and watch for a rally into the summer to near 14.50-15.40.

Suggested Trading Strategies:

1) Buy the October sugar 11.50/14.50 bull call spread for 60 points and also look to sell the October 10.50 put at 44. Hold the position for a test of 14.50 October sugar, and risk a total of 50 points.

2) Alternatively, buy the September sugar 11.50 call at 61 points with an objective of 285. Risk 35 points from entry.

3) Buy 6 October 15 cent sugar calls and then sell 1 October sugar futures at the market. Risk the combination to a net loss of $1,200. For the short futures position, use an objective of 10.80. For the long calls, use an objective of 15.60 basis October futures.