222 S. Riverside Plaza
Suite 900
Chicago, Illinois 60606
(312) 373-5000

R.J.O'Brien

THE HIGHTOWER REPORT

Special Report

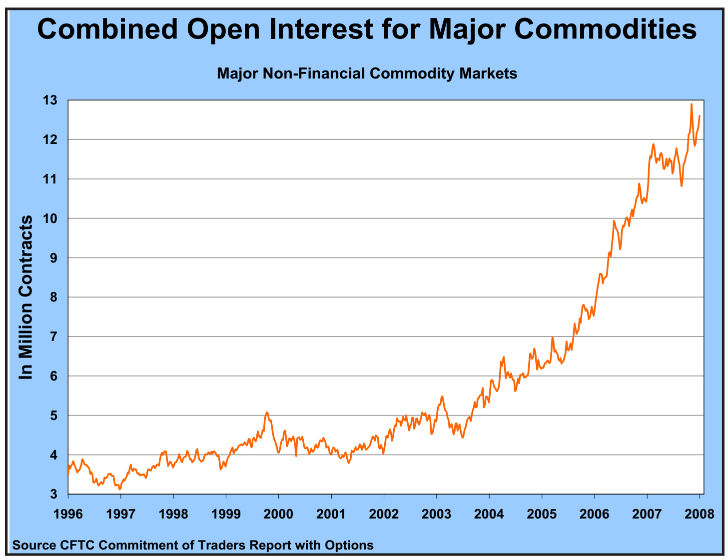
January 31, 2008

The Battle for Inventory

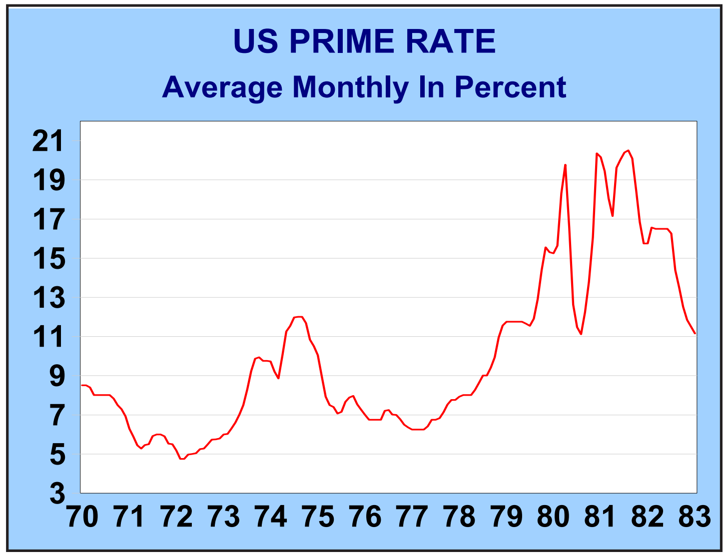
Much has been written over the past year about the worldwide battle for acres as a key underlying factor in bull markets for corn, soybeans, wheat, barley, rapeseed, etc. While the acreage factor will continue to be a critical issue for years to come, we are starting to see that markets have a limited ability to reassign large amounts of acreage over the short term. In the last few months, for example, we have seen Brazil's failure to substantially increase soybean acreage despite $9 to $11 soybeans at planting time, and we have seen an actual drop in US hard red winter wheat seedings despite record high prices prior to planting.

And at a time when corn and soybean farmers in the US are making their sowing plans for 2008, evidence is piling up that the US soybean crop may find it hard to win back the acres that it lost to corn in 2007, despite record high prices for soybeans.

Since large-scale shifts in acreage do not appear to be in the offing and USDA projections show continued tightness in stocks for many commodities well into 2009, users of basic commodities may be increasingly forced to enter into a very different kind of "battle" this year, a battle for inventory.

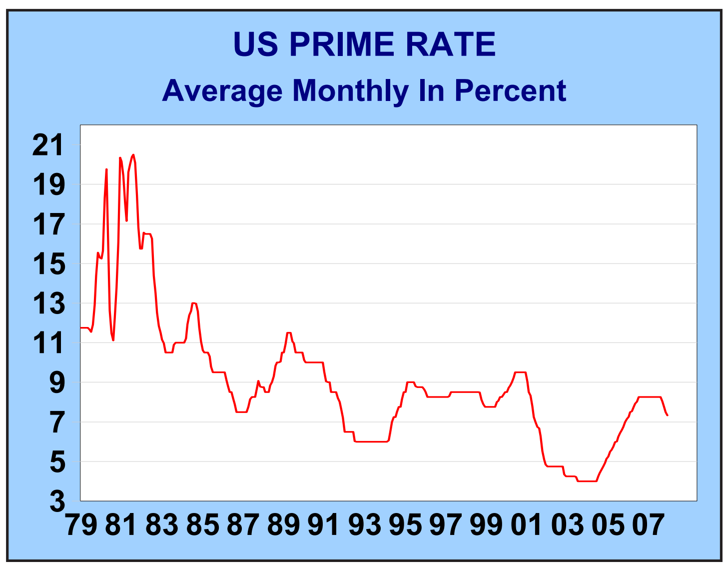


The battle for inventory could reverse deeply held convictions that have been at the heart of world business practices for the better part of a generation. The last comparable shift in attitudes occurred in 1980-81. It came at the end of an era, 1973-1981, when almost any physical asset, from precious metals to art to real estate, had a very strong tendency to appreciate in value. Having a little extra inventory, therefore, came to be viewed as a positive thing by businesses and investors alike. In the grain business, most farmers with a little extra corn or soybeans felt that they could sell on the next bounce, and merchandisers and end users viewed excess inventory on the books as a cushion against supply disruptions or the next wave of buying by the Soviet Union. Many businesses were not fully aware of how expensive this unneeded inventory was because they often did not have the accounting practices (much less software) that gave them hard data on how much inventory they really needed on a week-by-week basis, and they certainly did not fully segregate the cost of borrowing to finance that unneeded inventory.



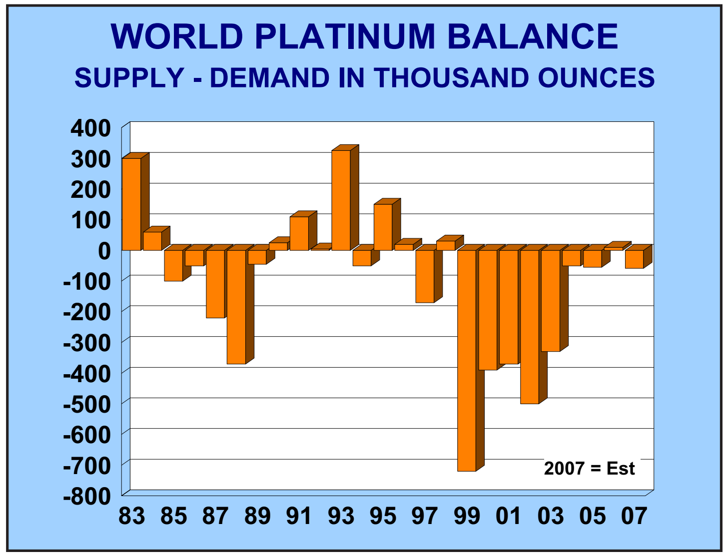
The Moment of Truth

By 1980, the American public had decided that they too wanted to invest in appreciating "things" like corn, soybeans, pork bellies and precious metals. A summer drought that year caught the attention of this eager public, and spec longs poured into the corn and soybean markets. Open interest surged to record levels in corn, which traded near its all-time highs all the way through the tail end of harvest, even though the drought had long since ended by then and overall supplies, including grain held in government programs, were huge. The higher harvest prices induced a flood of farmer selling all through the fall, and by early December this flood of selling in the cash markets finally outweighed the flood of new spec longs pouring into futures. Margin calls started hitting the spec 'longs' instead of the grain elevator 'shorts,' and the bull market came to a crashing halt. So too did the idea that excess inventory was a valued asset.



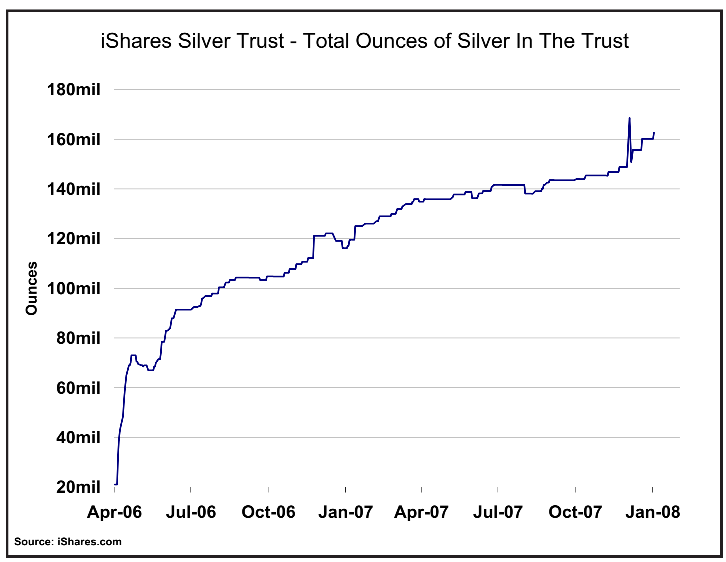
Most importantly, this peak in inflationary psychology coincided with a surge in interest rates as the prime rate ticked up to 21.5% in December, 1980. Farmers, merchandisers and end users came to the sudden, collective realization that the world was entering another period of protracted oversupply in grains, a situation that is actually the historic norm in

America. These events coincided with the growing popularity of the 'just-in-time' inventory management practices that had been honed to near perfection by Japanese car and electronics manufacturers during the 1970s. The combination of oversupply, ultra high interest rates and new business practices quickly turned the idea of owning extra inventory into financial heresy of the highest order. Accountants, bankers and MBAs descended on America's businesses to preach the gospel of wringing every last ounce of unnecessary corn, wheat, cotton, copper or wing nuts out of every conceivable supply 'pipeline.' To a large degree, the gospel of just-in-time inventory control has prevailed right up to the present – or at least into 2007.



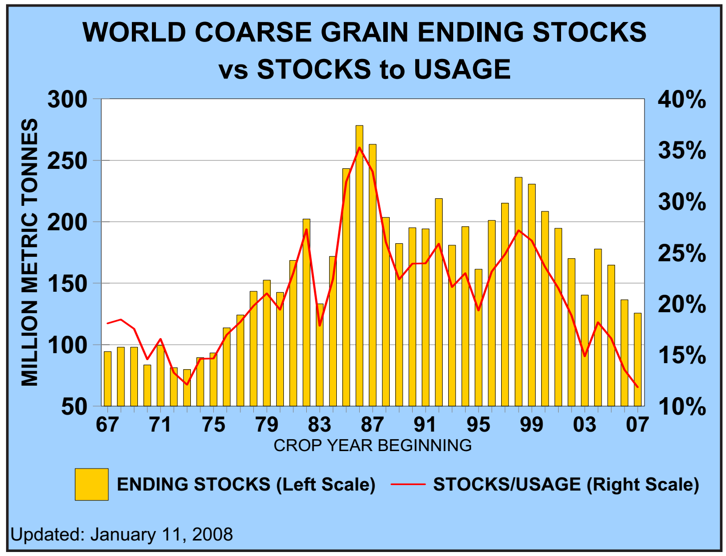
The Pendulum Swings Back

In 2008, however, we find ourselves in circumstances that are directly opposite those that prevailed in 1980-81. Users of commodities and manufactured goods now have business models that rely on weekly, or even daily, calculations of their precise inventory needs. The globalization of the past quarter century has made them comfortable with the idea that basic inputs can be bought almost instantly from cheap and liquid markets around the world and then shipped to their loading docks in a matter of days, or even hours. These models have been working very effectively for years for well-managed companies, and the occasional price spikes that have come along the way have been viewed as temporary annoyances that were likely to disappear before the next business cycle rolled around.

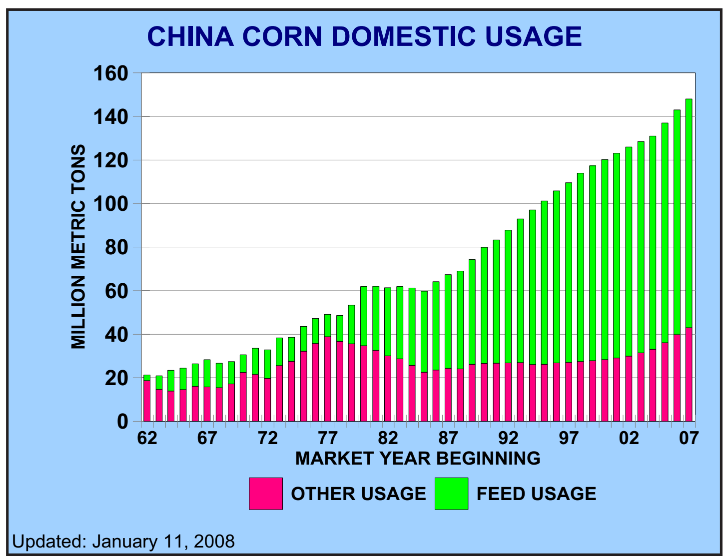


But the "annoyances" caused by historic rallies in 2007 and 2008 are not proving to be so temporary. They have chewed deeply into profit margins at some the world's largest food companies and resulted in permanently lost business for some smaller ones. This is causing a broad array of market participants from US farmers to millers, bakers and manufacturers to the governments of China, Russia, India and Pakistan to rethink the just-in-time mentality. A little extra inventory is starting to be seen as a good thing. Instead of bathing a balance sheet in red ink as was the case in the high interest rate environment of 1980, extra inventory in 2008 may actually save the balance sheet by being a hedge against protracted bouts of commodity inflation and supply disruption. Just-in-time is being replaced by just-in-case.

This could mean that farmers, manufacturers and countries will all begin to factor slightly higher levels of inventory into their "business models." These market participants may hold that inventory in a variety of formats ranging from national strategic reserves to larger and more term positions in futures and options markets. Whatever the means of ownership, these are fresh longs that could be both strong holders and long term participants.



But the biggest long term stake holders in the battle for inventory may end up being commodity index funds. Their participation in commodity markets skyrocketed in 2007 as large and small investors throughout the world decided to diversify their holdings of equities and bonds to include some commodities. These new owners are more likely to be buyers rather than sellers and, like end users and governments, they could also be strong holders who are in it for the long haul. The potential size of fund participation could be startling. For example, at the end of the 2nd Quarter, 2007, all retirement accounts in the US held an estimated $17.4 trillion. One percent of that total is $174 billion. Five percent – not an unreasonable amount to diversify into a major investment vehicle – comes to $870 billion, and that is just US retirement accounts. This may be more money than commodity markets can absorb, and while investors can certainly take money out as easily as they put it in, there would seem to be a number of circumstances that are likely to favor them putting more money in, such as: declining equities markets, a declining dollar, well-publicized new highs in key commodity markets, and financial advisors preaching the time honored mantra of diversification. The rising popularity of exchange traded funds (ETF's) and now a push by several firms to offer a broader range of commodity specific exchange traded commodity funds (ETC's) simply expands the number of "doorways" that ordinary investors can use to enter commodity markets.



Behind all of these factors is a single great driving force: liquidity. The way that policy makers now think about liquidity may represent the greatest shift of all in comparison to the attitudes that prevailed in 1980-81. At that time, Fed Chairman Paul Volcker was well into the process of squeezing the inflation of the 1970s out of the US economy by effectively reducing liquidity. He did this by raising the Fed Discount

Rate to the point where the prime rate was pushed to a peak of 21.5% just as the corn market was rolling over in December, 1980.

In contrast, by 2008 it seems as if a growing proportion of the world's central bankers have come to rely on the power that increased liquidity has to quickly resolve a host of economic problems. And they seem willing to increase it early and often. Liquidity has been forcefully added to resolve the Mexican Peso crisis of 1994-95, the "Asian Contagion" of 1997-98, the Ruble Crisis of 1998 and now the sub-prime crisis. Until the latest of these crises, central banks have been careful monitors of the potential inflationary effects of stimulation, but with the latest round of rate cuts the Federal Reserve is starting to give the impression that it is willing to over-stimulate and risk an inflationary uptick if that's what it takes to stave off a global slowdown. It is truly a new day.

Conclusion

Whether the prevailing pro-liquidity consensus will prevent a decline in the global economy and equities markets remains to be seen, but the liquidity factor should provide a powerful and consistent tailwind for commodities. This could result in powerful rallies by certain lower-priced commodities and continued probes into new all-time highs by a number of higher-priced markets. Some strategies which we feel could work during early 2008 are listed in the next section.

Suggested Trading Strategies

Corn:
1) Sell the March 510 corn call and buy the May 530 corn call a net cost of 10 cents and hold until May corn hits next upside objective of 549 1/2. If the timing is right, the March 510 will expire worthless and the trader will just own the May 530 call. Risk a total of 8 cents on the trade.

2) Buy July corn near 510 and also sell the July 580 call and buy the July 500 put for protection. The options will limit the upside potential of the trade but will also offer a set risk on the downside.

Soybeans:
1) Buy November soybeans at 1217 with an objective of 1358 and maybe 1414. Risk to 1196.

2) Buy the November soybean 1240/1360 bull call spread for 39 cents and also sell the November soybean 1040 put for 39 cents. Look for a gain of 80 cents on the trade and risk 20 cents total on the entire spread position.

Silver:
Buy a May silver $18.25 call for 70 cents and then sell a March silver $18.25 call for 24 cents. Risk the combination to a net loss of 50 cents and use an objective of $19.90 basis the May futures contract.

Sugar:
Buy the May sugar 13.50 call for 49 and then look to sell the April sugar 14.00 call for 22. Risk the combination to a net loss of 40 ticks and use an objective of 14.20 basis the May sugar futures.