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Canadian Market Outlook

Index

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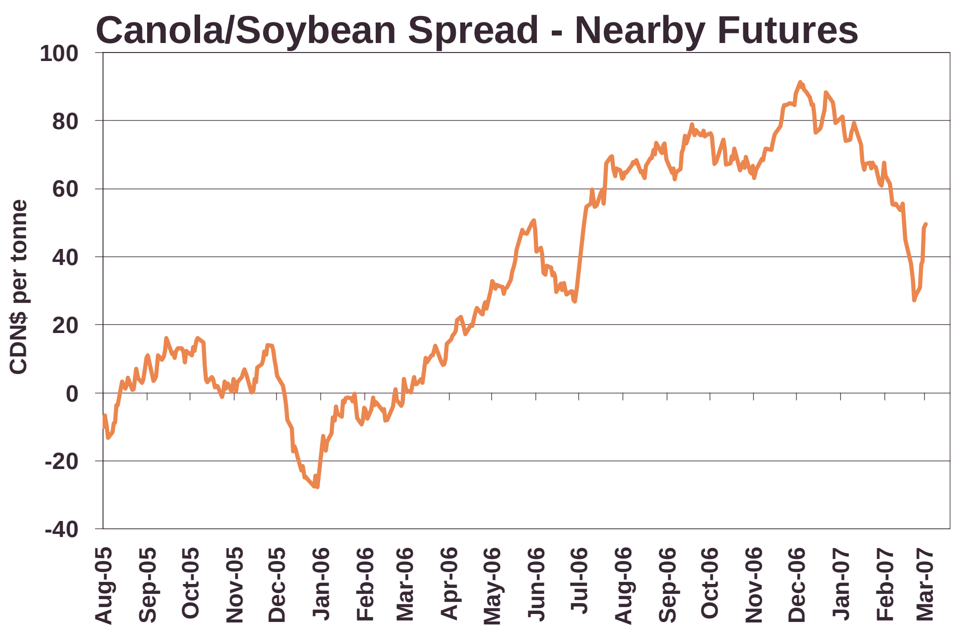
1) Canola Steady Despite Weak Soy Complex

The canola market held up surprisingly well this week, despite the fact that the soy complex all but collapsed. Bullish canola traders were frustrated a few weeks ago when canola refused to rally in the face of contract highs in the soy complex, but they are probably breathing a sigh of relief this week, as canola now has less selling pressure than the soy complex.



There is no doubt that the recent sell off in canola is discouraging farm sales to some degree. On the other hand, many producers are continuing to move canola ahead of road bans and seeding. This steady movement will cap rally potential in the next few weeks.

Funds have also been big news in canola, as they exit extremely large long positions. Some traders had been estimating that spec and index funds were holding long positions of more than

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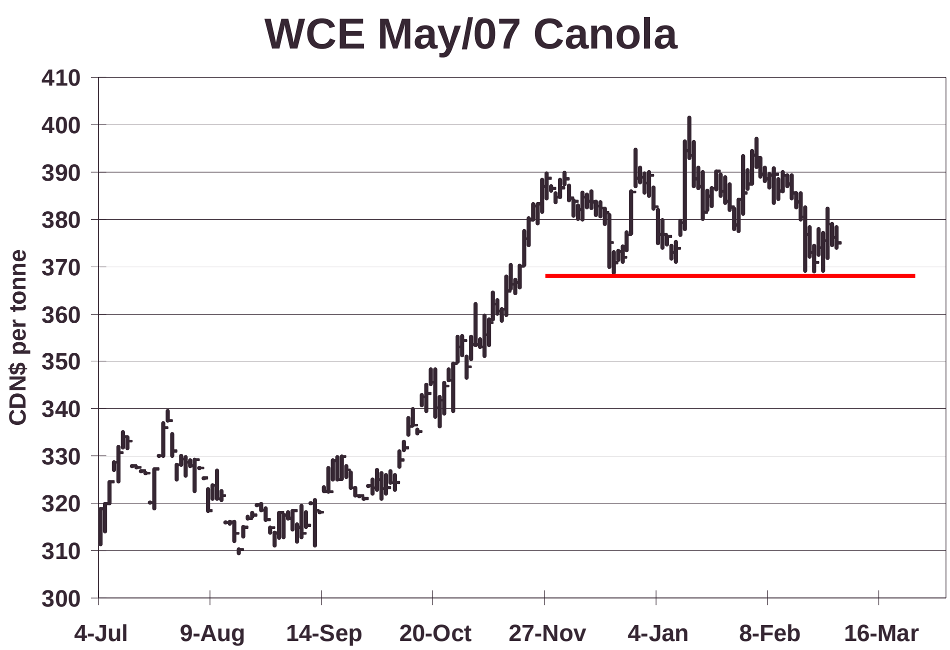
30,000 contracts in canola just two weeks ago. Those same traders are now pegging the combined fund long position at less than 10,000 contracts.

The fact that the spec position has been reduced so sharply takes some of the risk of an even sharper correction out of the canola market. However, we doubt that the funds are ready to pack it in on canola just yet. A rally in May canola above recent resistance and some key moving averages in the $383.00 region could easily trigger a fund buying spree. Conversely, if May canola breaks key support at $368.70, we would expect to see another round of aggressive fund selling.



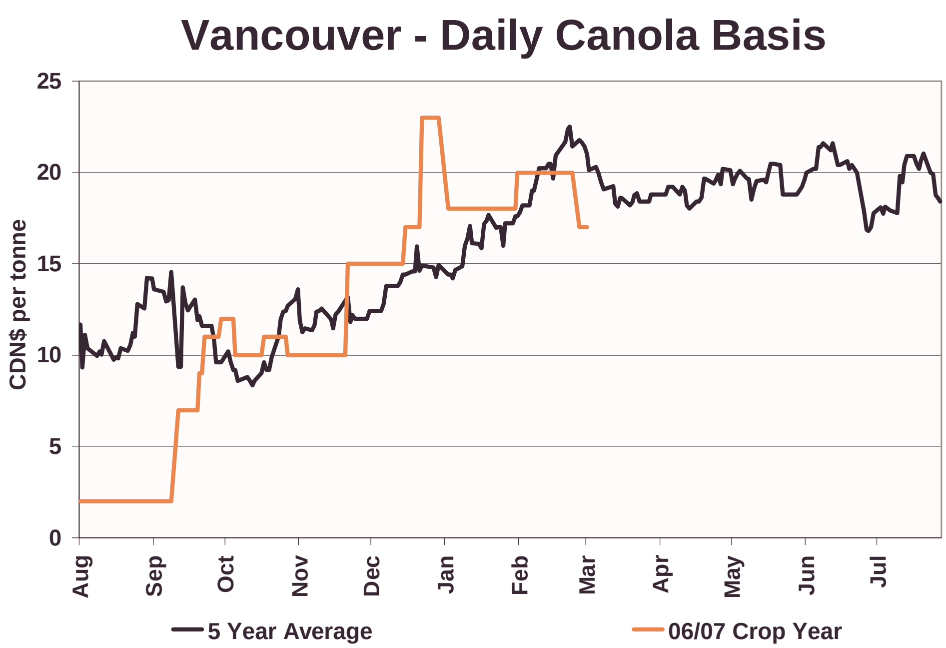
What will be interesting to see is how far the market breaks if that fund selling is triggered. As we mentioned last week, China had been looking for a break to $366 in the May futures to buy canola. This week, we received confirmation that China bought one cargo of Canadian canola for April delivery at the equivalent WCE May futures of $377.00 per tonne. Sources indicate that China is still shopping for as many as three more vessels, so there could be some significant buying interest if the funds do decide to sell canola.

On a side note, we find it interesting that China would be shopping for as much as 240,000 tonnes of Canadian canola when their own rapeseed harvest will begin in a little less than two months. We also find it interesting that China has been an aggressive buyer of Indian rape meal in the last week or two. This illustrates the current shortage of meal in that country, due to the poor rapeseed crop harvested there last year. Although Indian rape meal is a competitor for canola seed imports to China, rape meal inclusion rates in feed rations are somewhat lower than canola meal rates. As such, strong meal demand in China should ultimately support the canola market.

Another country that has been mentioned as a potential canola buyer frequently over the last two weeks has been Mexico. Merchants from at least one Canadian grain company are in Mexico this week, which could have triggered some sales. We continue to hear reports that Mexican buyers are interested in locking in canola on breaks into the mid $360's on the May contract. Once again, the market has not been able to break that low so far, likely because of those resting buy orders.

This week, the CGC released January export numbers, and total canola movement was better than our expectations. Japan, China and UAE all took more canola during the month of January than our estimates. Mexico was notably absent from the canola market during January, likely in response to high prices at that time. Still, the lack of movement to Mexico during January may have caused some pent up demand and may help to explain the aggressive sales that have occurred to that country since then.

The rail strike had hurt the canola market, and we're convinced that some export opportunities were missed during the disruption. That being said, rail movement appears to slowly be returning to normal, and the export line up for canola is beginning to rise once again. The fact that canola is moving through the system again has been reflected with weakening basis levels in Vancouver in the last week.



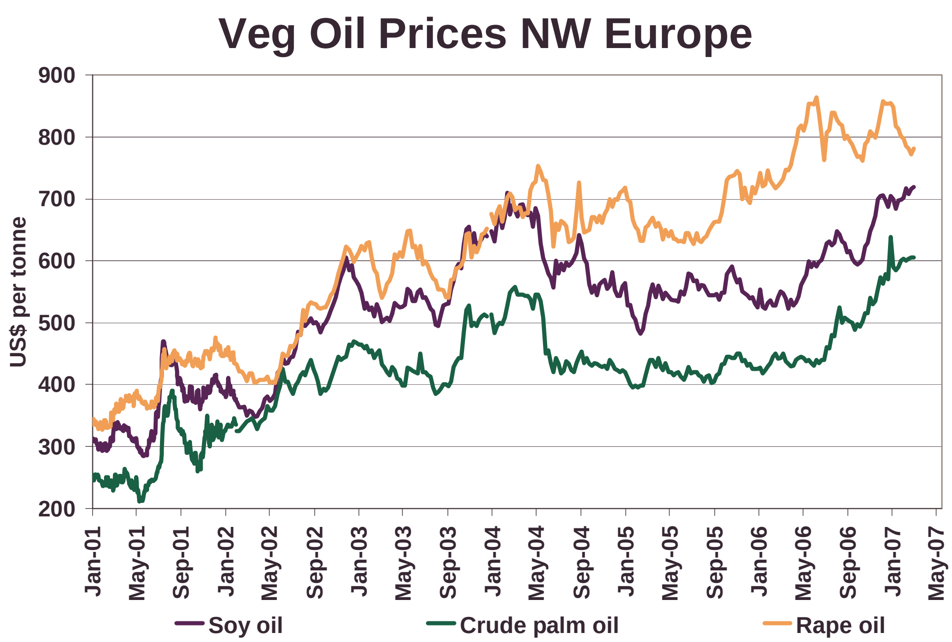
The lower export basis, combined with recent weakness in the Canadian dollar and softer futures prices should encourage more demand for canola in the days ahead. However, we can not rule out the possibility of another sharp sell off in canola if fund selling resumes. The recent decline in canola futures are a sign that this market can change very quickly. Even though we look for seasonal strength later in the growing season, canola is vulnerable to further weakness over the next four weeks. As such, producers are advised to be sure that they are up to our current recommended sales level of 50% on old crop canola.

With current volatility in the canola market, we are also going to recommend our first new crop sale of the 2007/08 crop year. Jan 08 canola has been trading in the $396 area over the last while. Even with a $20 basis, this would allow the producer to deliver canola in November or December for $8.50 per bushel. While we hope that this will be the worst sale of the crop year, it seems prudent to get some canola on the books for new crop. This will allow cash flow, albeit after harvest.

End users will want to be patient with canola purchases until the short term trend becomes clear. It is important to remember that our long term outlook is still bullish, as weather scares and production issues still lie ahead. As such, a sell off over the next few weeks brought on by speculative selling should be viewed as a buying opportunity.

2) Sign Of The Times For Biodiesel?

It's no secret that rapeseed oil values in Europe have been sliding since the start of 2007. This slowdown has affected demand for Canadian canola, as falling EU rape oil prices are curtailing demand from third party crushers in Canada, United Arab Emirates, China and the US who have been supplying canola oil to Europe.



This week, as many as 30 companies in Germany (Europe's largest biodiesel maker) began a court challenge of the government's change in taxation policy in that country. The group claims that new taxes on biodiesel have hurt demand, cutting into sales and returns.

The German government introduced new taxes on biodiesel which went into effect at the start of the year. Up to that point, the tax advantage on biodiesel meant that most motorists bought B100 biodiesel, as it was cheaper than conventional diesel. Now that the taxes have been added, consumers are apparently switching back to conventional diesel. While biodiesel is reported to still be selling at about a 5 cent per litre discount to conventional fuel, analysts estimate that it takes a 10 cent per litre discount to offset lower mileage and higher maintenance costs and encourage consumer demand.

The net result has been a sharp drop in biodiesel consumption in Germany. According to industry analysts, demand has dropped between 25 and 30% compared to the fourth quarter of 2006. Mandated biodiesel inclusion rates were introduced at the start of 2007. However, it would only take about 1.5 million tonnes of biodiesel to satisfy those requirements, versus existing processing capacity of nearly 2.7 million tonnes. If all announced plants are constructed, the excess capacity could reach as high as 2 million tonnes by the end of 2008.

The net result has been a build up of rape oil stocks in Europe, which is adding pressure to prices. German biodiesel manufacturers are currently only running at about 75% of capacity, in an effort to offset the rising stocks. One major producer has reportedly shut down altogether and several more plants could be ready to do the same in the next few weeks.

This situation provides sobering thought to canola industry observers. Although there has been considerable optimism about the potential market impact of biodiesel demand, Europe's example shows that this industry is not without its problems. A dependency on government subsidies is a definite limitation for biodiesel demand, which canola traders will need to remain conscious of. Germany's consumers show that unless the price is right, "green" fuels may not be as popular as previously believed.

3) CWB Wheat Pricing

The release of the 2007/08 PROs this week added another pricing signal for western Canadian wheat growers. Just as importantly, values for 2007/08 fixed price contracts and basis contracts were released. Farmers are now asking whether they should be locking in some of their expected production and, if so, which contracting method is best. The answer (as it so often is) is, "It depends." Price relationships between various wheat classes look different this year because of changes to grade spreads and basis levels.

First, the PROs. At Grainworld, we heard that the CWB is expecting a return to a lower grade pattern and have increased the grade and protein premiums compared to the 2006/07 values. The PROs for high quality CWRS wheat are higher than last year's, while the lower quality CWRS dropped in value. In addition, PROs for mid-quality wheat classes generally declined slightly from the 2006/07 PROs.

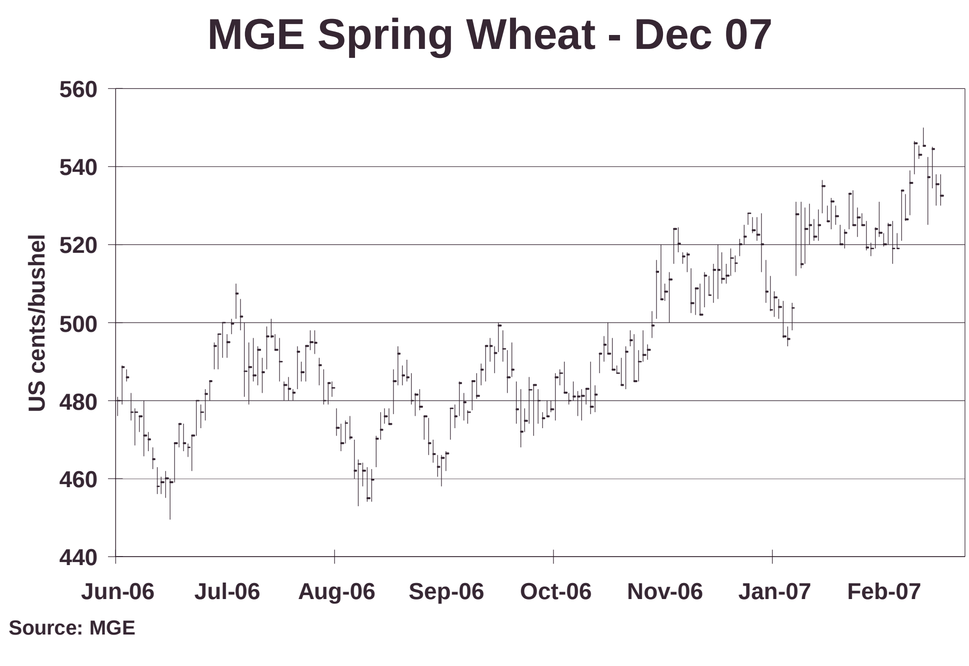
Selected CWB PRO Values ($/tonne in-store)

	Feb 07 PRO 2007/08	Feb 07 PRO 2006/07	Feb 06 PRO 2006/07
1CWRS 14.5%	228	220	214
1CWRS 13.5%	220	216	202
2CWRS 13.5%	214	212	196
3CWRS	194	199	164
1CWHWS 13.5%	220	216	202
1CPSR	191	194	159
1CPSW	191	194	165
1CWRW	191	192	156
1CWES	204	204	168
1CWSWS	200	201	174
CW Feed	170	181	118

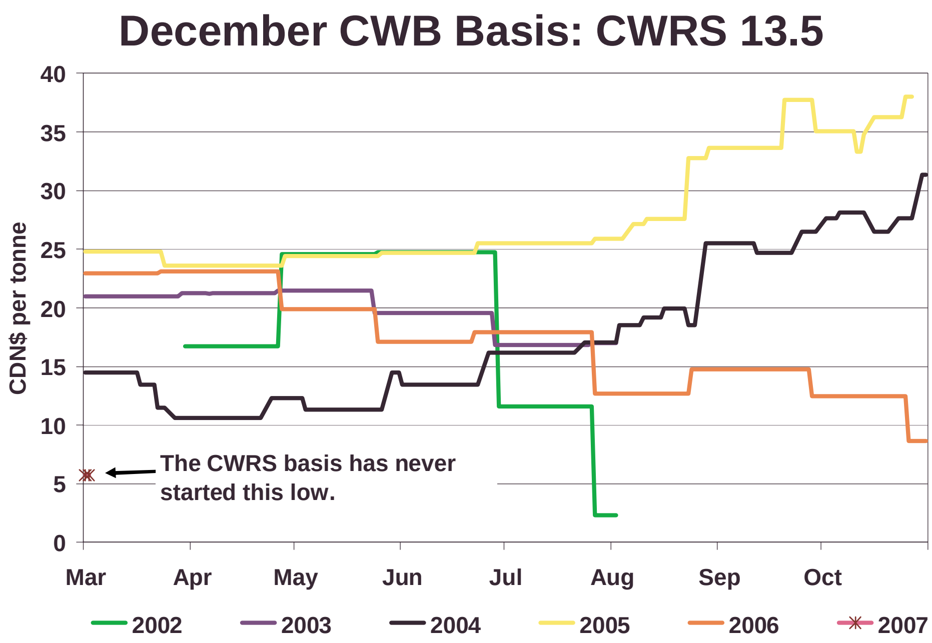
We have a few other observations based on this week's PROs. First, interest in CWES wheat has certainly picked up in the past year and this wheat class is now showing a more sizable premium relative to CPS wheat. Red winter wheat has also recovered relative to CPS wheat. In the past, CPS white wheat has traded at a few dollar premium over CPS red wheat. However, this season it has fallen back to par value. We're still waiting for hard white spring wheat to be priced independently of hard red spring wheat. Based strictly on the PROs, the bright spots for 2007/08 are high quality CWRS wheat and the CWES wheat class.

When we look at the fixed prices offered by the CWB, they are $13-15 per tonne higher than the PROs for all wheat classes. From that perspective, they look fairly attractive. After all, if a farmer can lock in 35-40 cents per bushel more than the PRO by using an FPC, it looks like a good deal. These price differences are a fairly good indication that the CWB is slightly bearish (or at least cautious) for the coming year. If the pooled returns are lower than December 2007 wheat futures less the CWB basis, it indicates the CWB analysts expect the market to decline later in the crop year when they start to make sales.

So far, the deferred wheat market doesn't really look weak at all from a technical standpoint. In fact, December MGE wheat is within striking distance of new contract highs earlier this week and the long-term higher trend is still in place. That's not to say that the rally won't break at some point in the year, but it certainly isn't showing any signs of it yet.



One of the other things we have noticed this week is that the CWB basis levels vary widely depending on the class of wheat. In general, basis levels for CWRS, CPS and SWS wheat are very poor compared to previous years. In our earlier projections, we had tried to project fairly conservative basis levels for CWRS wheat of $10 over December 2007 MGE futures. It appears that we weren't nearly conservative enough, as the CWB set the basis level for CWRS at only $5.73 over the futures.

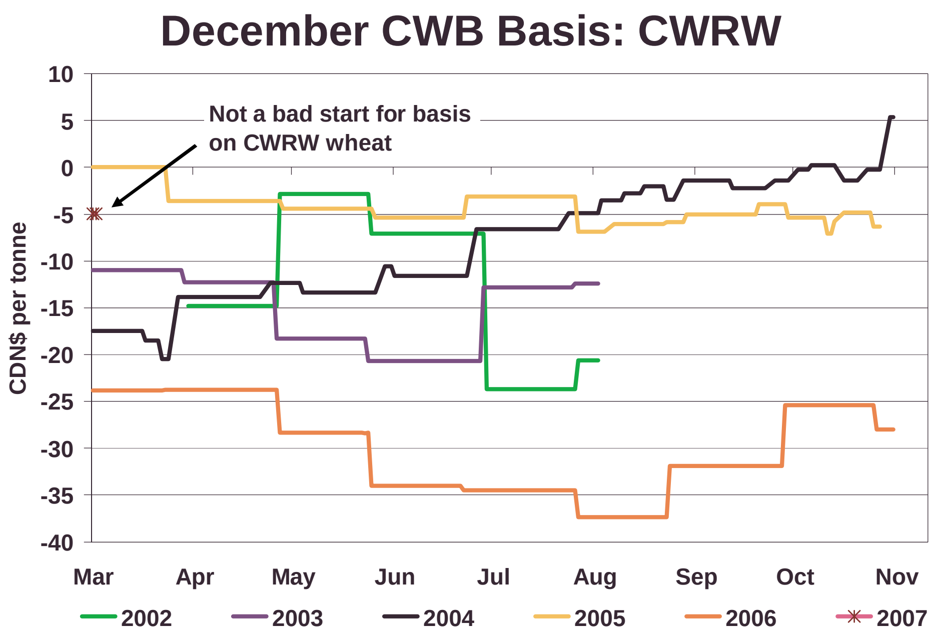


We are quite curious about the Board's rationale for setting the basis level at such a poor level. On the one hand, the CWB analysts attributed last year's lousy basis levels to the high quality crop in 2006. At the same time however, they widened out the grade spreads on the 2007/08 PROs because they expect a return to a more normal (lower) grades in 2007, which should also argue for a return to more typical (higher) basis levels.

In addition, the market is generally expecting a drop in red spring wheat acres in Canada and the US which should support values for CWRS wheat. The wider premium in the PROs for durum relative to milling wheat should also encourage an even larger shift from red spring wheat to durum acres in Canada.

The net result of the low basis levels for CWRS, CPS and SWS wheat is that the FPC prices are lower than expected. After all, if basis levels for these wheat classes were closer to historical norms ($10-15 per tonne better than those just announced), FPC values would be about 65-85 cents per bushel above the PROs. We would rather not imply that the Board is trying to keep the pool accounts from looking unattractive, but it certainly has that appearance.

Meanwhile, basis levels for CWRW and CWES are actually not too bad compared to historical levels and farmers may want to capitalize on them. Based on current CWB basis levels, the FPCs for CWES and CWRW both work back to approximately $4.35 - $4.40 per bushel in Saskatchewan.



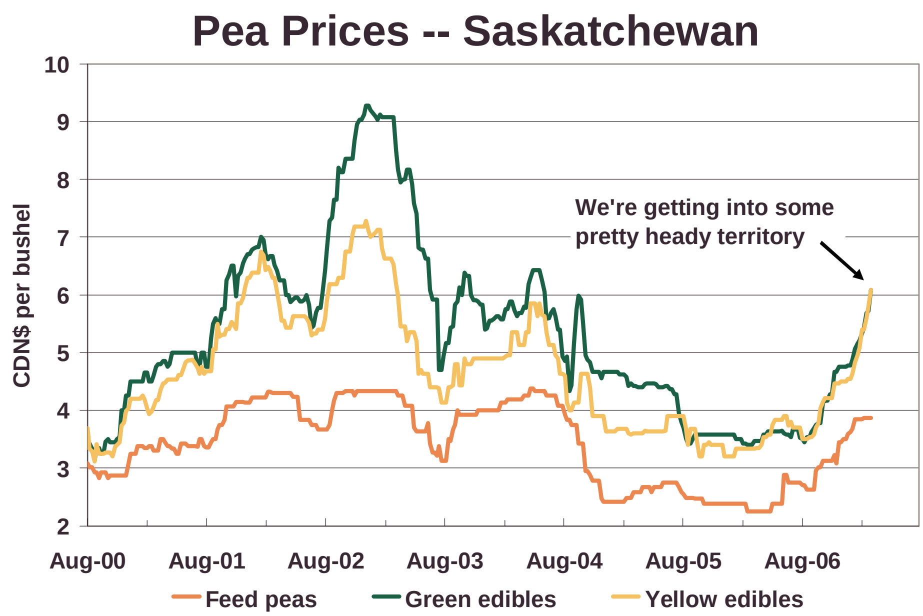
Looking at these basis levels that range from bad to decent, farmers should use different marketing strategies depending on the class of wheat they are growing. The poor levels for CWRS, CPS and SWS wheat suggest leaving the basis open for the time being. Those who are considering selling CWRW or CWES wheat to the Board may want to lock in basis, but there is no rush to do so yet.

Keep in mind that deferred wheat futures are still in an uptrend, so we don't feel panicked into locking in the futures price on any of the wheat classes yet. Even so, corn is driving the market right now and if it does break lower, it's time to get some wheat priced. The bottom line is that the pool accounts are a sad second-best right now. When the time comes to pull the trigger on wheat pricing (and assuming basis levels are unchanged), we would recommend futures-first basis contracts for CWRS, CPS and SWS wheat. Meanwhile, for CWRW and CWES, the fixed price contract would be the best alternative.

Of course, don't forget that the non-board market is expected to be a much larger factor this year, especially for anyone growing mid-quality wheat close to an ethanol facility. Farmers should be keeping an eye on that market to compare values against the CWB. For example, bids of $4 per bushel for October delivery are available at certain locations in Alberta and Manitoba, compared to the PRO for 3CWRS that works back to roughly $3.75-3.95 per bushel in Manitoba and Alberta respectively.

4) Taking a Fresh Look at Peas

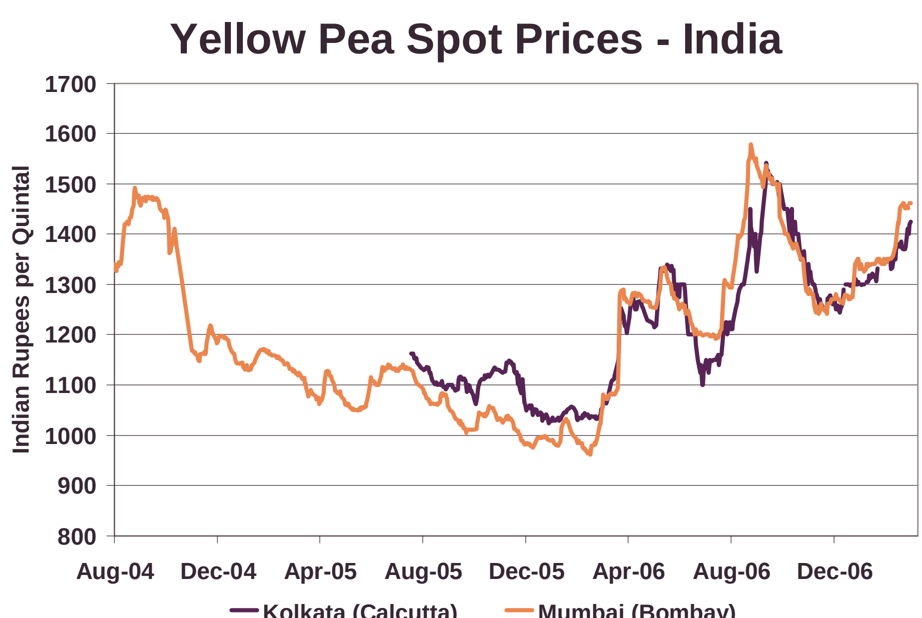
It was only a few weeks ago that most market observers were predicting that field peas wouldn't be able to compete in the race for 2007 acres. At the Crop Production Show in mid-January, most people were still calling for 2007 pea acres to drop – in some cases, by a lot. It's amazing how much putting a "6" in front of prices will make people reconsider their seeding plans. The big jump in nitrogen fertilizer prices certainly doesn't hurt either.



Source: SAF

Back in early February, we were still calling for a 6½ percent drop in acres, and we were just starting to consider that high fertilizer prices might help add a few more acres of peas. That was before the latest rally pushed spot prices over the $6 per bushel mark. As a result, the odds are tipping toward unchanged (or higher) acreage in 2007.

Even so, a modest increase in acres isn't considered all that bearish for the pea market. In fact, assuming trend yields, a 5 -10% increase in acres would be needed to enable exports to stay steady with our projections for the current crop year (2.15 million tonnes) and still keep ending stocks around 250,000 tonnes – a moderately tight level.

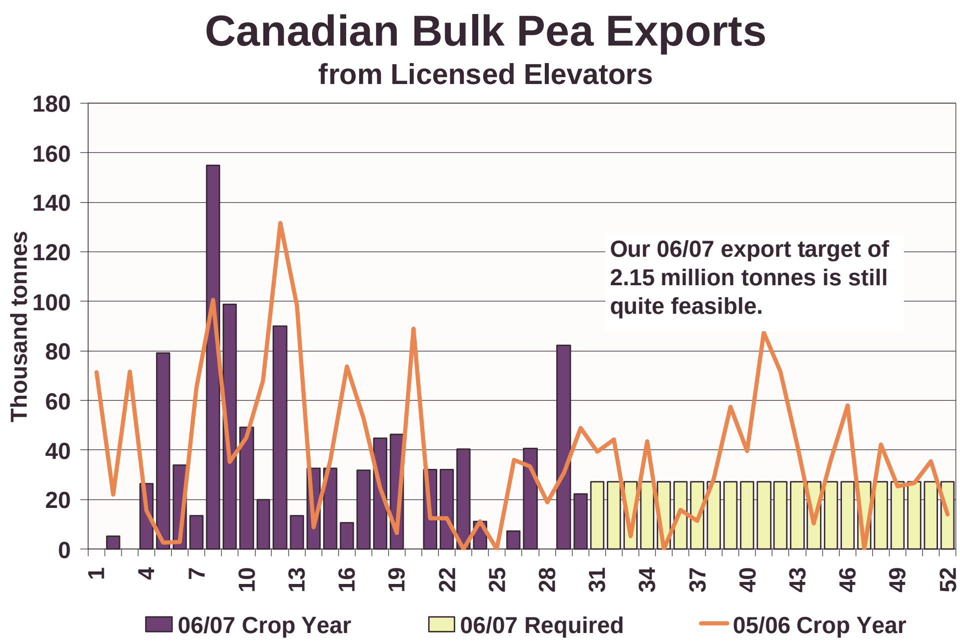


Source: NCDEX

This year, the Indian market is dominating Canadian exports more than ever. So far in 2006/07, India has taken 60% of licensed exports (not including container shipments). As a result, rising prices in India are the key driver for Canadian domestic prices. We knew that pea acres in India were lower this year, but it's quite revealing that prices are climbing during the harvest of their rabi (winter) crop. This suggests there may be additional yield or quality problems and bodes well for import demand and prices going forward into the year.

So far, green peas have been unable to establish a premium over yellow peas, mostly because of India's dominance in the market. As a result, we would expect that the shift out of green peas toward yellows will continue in 2007, because of the higher quality risks for green peas. This expectation is keeping new crop bids for greens 50-75 cents per bushel higher than yellows, even though spot prices are on par.

The final message is that pea prices are expected to remain firm through the spring months, simply because stocks are getting tighter. Weekly exports have remained quite strong in spite of lower supplies this year, and the remaining peas are in stronger hands. Therefore, we expect that prices over $6 per bushel should be available for some time



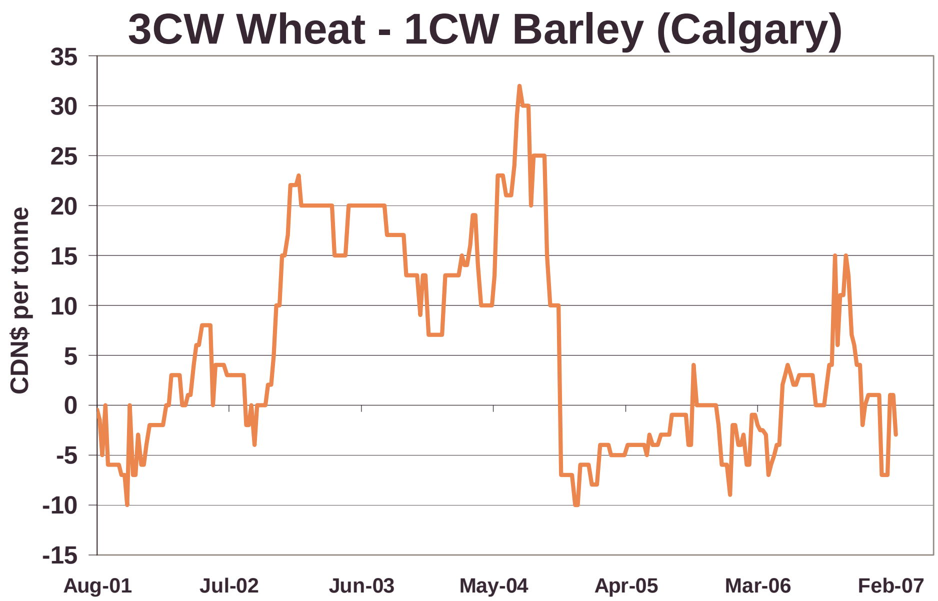
<u>We've advised 50% sales of old crop peas for some time, on prices over $5 per bushel for edibles and $4 for feed peas. While there's no rush to add sales of edible peas, farmers may want to start selling small increments at values over $6 per bushel. On the feed side, however, the spread between edibles and feed peas is now over $2 per bushel and we think that feed peas should begin to respond soon to the rise in both edible pea values and the rally in the feed barley market as well. As a result, we would be a little more reluctant to be selling feed peas right now.</u>

5) Feed Wheat Attracting Demand

Over the last few weeks, cash feed barley prices have shot up noticeably, while feed wheat prices have only posted modest gains. Both markets are gaining strength from the corn market, and the fact that Western Canadian feeders appear to have been caught short (again). The net result of the swing in these markets is that feed wheat is trading at a discount to barley once again. Wheat had been trading at a discount to barley since the poor quality harvest of 2004. However, the market had returned to its normal premium to barley after last fall's harvest provided better quality. Feed wheat stocks declined and prices rose.

The rally in all feed markets this winter has driven prices high enough to attract milling quality wheat into the feed system. The result is a much larger supply of feed wheat than analysts were counting on last fall and slightly flatter feed wheat prices than one might have expected.

As the chart below shows, 3CW wheat is trading at a slight discount to barley in the Calgary market. In Lethbridge this week, we saw reports of feed wheat trading as much as $5.50 per tonne lower than feed barley. This is an important development, as experience tells us that demand for feed wheat from the cattle sector will tend to rise when prices drop between $5 and $10 per tonne below barley.



Source: LFB

The message to traditional end users is to be cautious about waiting to make feed wheat purchases. If wheat continues to trade below barley for very long, you can expect to see a lit more competition from the cattle sector and other buyers who would normally stick to barley.

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