 By Jerry Gulke

The End of an Era Starts a New One

The monthly corn chart tells a story that exemplifies the relationship between price discovery and the economics of supply and demand. Price discovery theory dictates that the marketplace will never run out of a commodity.

When there is an oversupply, prices will get low enough, causing more to be used. Conversely, in times of short supply, prices will rise, incentivizing a supply increase. As prices continue to increase, demand curtails until an oversupply exists. Increasing the supply becomes more viable while demand begins to curtail and an oversupply evolves, and the process starts all over again.

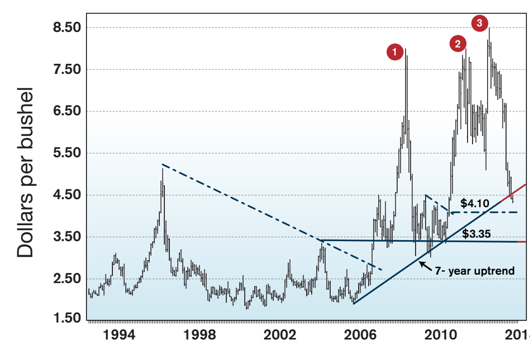
Equilibrium—when supply equals demand—lies somewhere in the middle of the process but is seldom stable and becomes a moving target. The larger the number of participants in the universe of supply and demand, the more erratic prices are.

Create Demand. The precursor of the price volatility that we've seen during the last six years began in 1995/96 when China entered the market as a big corn importer. The U.S. saw prices more than double in 18 months. Subsequently, it took 10 years of subdued prices under government intervention before some aspect of an energy policy evolved, mandating the eventual use of 5 billion bushels of corn to make ethanol.

All the buzz about the possibility of running out of corn to produce ethanol in 2008 took prices above the 2004 high of $3.35. In 2003/04, prices responded with a 50% increase, which came on the heels of a 0.5 billion-bushel increase in exports. Farmers responded by growing an additional 1.8 billion bushels, which doubled carryover to 2.1 billion bushels as of Sept. 1, 2005.

In response to the ethanol mandate, which called for using 5 billion bushels of corn, farmers expanded production by 15 million acres for a total of 93.5 million acres. That acreage would have been suffice with average yields. The sideways trading range after 2008 testifies to the fact that a corn price of $4.25 per bushel and 86 million to 88 million acres created enough production to match 13 billion bushels of usage. We still had ending stocks of more than 1.5 billion bushels and average farm prices less than $4.

Monthly Corn Price Review



Price is a great driver. Supply will eventually exceed demand, resulting in new price discovery. Source: Gulke Group

This happened before our competitors expanded production. Had it not been for the reduced production in 2011 and 2012, prices would not have created the global response we've witnessed.

Bull markets tend to perform in three distinctive moves. The chart shows how well this matches with 2008, 2011 and 2012. Once demand has been met with oversupply, prices often return to levels where it all started.

In our example, that would coincide with $3.35. While perhaps unthinkable even six months ago, price action and subsequent production response suggested it would only be a matter of time. It remains to be seen whether the current price adjustment to the oversupply will create a five- to 10-year sideways price range while global demand catches up, or if it's just a pause that refreshes before a return to 2011/12 prices. TP

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