

Economics & Stocks

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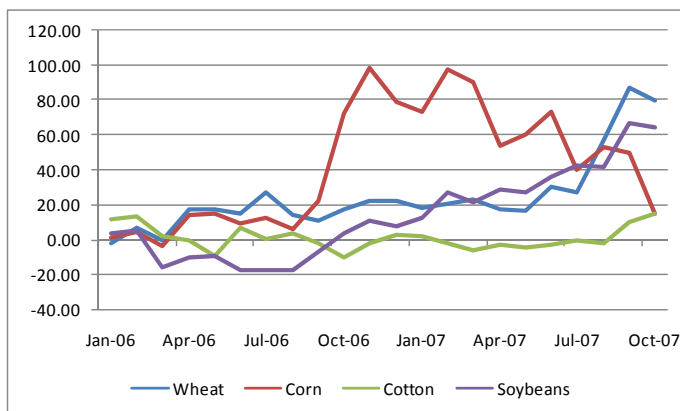
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Inside the Numbers – PPI November 2007

Summary:

Agriculture and all energy areas dominate the Producer Price Index Report once again for November. Two areas that are somewhat of a surprise were nonferrous metals, consisting of primarily copper wire; and waste paper, which is recycled paper, exported, as a raw material for paper. Agriculture again provided some interesting possibilities for analysis. For example, wheat and soybean prices increased significantly more than corn and cotton prices y/y, creating interesting implications for next year's planting season, fertilizers, animal feeds, and food costs.

Figure I: Y/Y Change in price of Wheat, Corn, Cotton, Soybeans – January 2006 to September 2007



Source: Department of Labor; SISR

and 11.4% increase y/y. The main growth in this sector comes from copper wire which is used for building, and generators and motors. Non residential construction has been strong despite the fact that housing has been weak, while turbine and generator growth in shipments have been significant leading to the likely increase in demand for copper wire (SISR, *Dollar likely to strengthen Against Major Currencies*, November 7, 2007). Another area of that has shown significant pricing pressure is the area

We have written extensively about the crack spread between crude oil and gasoline (SISR, *Refining margins Improving :But still Tracking Worse Q/Q but Better Y/Y*, Nov. 13, 2007; SISR, *Price of Gasoline Expected to Rise to \$4.00*, October 25, 2007), but what we have not commented on is the nearly 30% increase in heating fuels and natural gas prices. The impact on the consumer in conjunction with the high price of gasoline will certainly have an impact going into the winter months.

The real surprise in this report was the nonferrous metals increase of 2.8% m/m

of waste paper and wood pulp, both up 64% and 13% y/y respectively. Much of this we believe is going abroad as a raw material for recycled paper.

I. Agriculture and Associated Industries

Agricultural and its associated industries have been the most aggressive areas with respect to pricing in the last couple of years, with the possible exception of energy.

- A. Price of Wheat, Corn, Cotton, & Soybeans: Figure I highlight the y/y change in the price of wheat, corn, cotton and soybeans. Going into next year's planting season, soybeans and wheat have had a tremendous price increase y/y, whereas corn is somewhat flat. What makes this interesting is that the price increase in corn was the conditions that lead to the rapid increase in the planting of corn last season. Since soybeans are the ingredient for biodiesel fuels we have seen this commodity increase in a manner similar to that of ethanol last year. The implication here is that with the price increase in soybeans and wheat we will see more area taken away from cotton and perhaps even corn this year. This in turn will help push up the price of corn until some form of equilibrium is reached. We expect that equilibrium between the three products is still several years away, with ethanol and biodiesel fuels still in their infancy and the ultimate success of these products still years away from full comprehension.
- B. Fertilizer prices: Phosphates down -7.1% m/m; nitrogen down -2.7 m/m - We have written extensively about the fertilizer market (SISR, *Mosaic Company Initiation Report Overweight*, July 16, 2007; SISR, *Farm Economic Boom Nearing Top*, October 8, 2007; SISR *Silvinit Shipping Potash Despite Sinkhole, But Prices Increase 20%*, November 8, 2007). The November PPI report showed that the price for both Nitrogen and Phosphates fertilizers were declining, but from our report on the Silvinit sinkhole, we know that the price of potash has increased approximately 30% in the last month alone. We argued in the *Boom nearing Top* report that we expected the price of fertilizers to flatten out, then the sinkhole problem occurred and the price of potash increased. We believe that the next few months will tell a clearer story if these fertilizer companies have any pricing power here, and if the price increase in potash will hold, even though there is expected to be no loss of product due to the sinkhole problem.
- C. Animal Feeds and Food Prices: Animal feeds up 25.5% Y/Y & 3.1% M/M – Animal feeds have been up significantly particularly because of the price of corn. Fresh young chickens are up 12.2 % y/y, eggs for fresh use are up 62.6% Y/Y, but beef & veal and pork having not followed being up only 1/5% y/y and -1.5% y/y respectively. With respect to slaughter hogs, cattle and fryers we see the same pattern, -18.3, 4.8%, and 17.5 % y/y respectively. It is for these reasons that we have been overweighed chicken farmers and have been neutral with respect to hog and cattle farmers, in the food chain. The price increase in chickens is reflected the increase in chicken feed but chicken feed is only a subcomponent of the entire cost of raising chickens, giving the chicken farmers increased margins we have argued.
- D. Agricultural Machinery and Equipment: Agricultural machinery and equipment up 3.1% y/y & 0.7% m/m - It is interesting that although farm equipment has been one of the leading subsectors in the agricultural industry, pricing of equipment has not kept pace with the other growth sectors.

One possible explanation is that there has been a good deal of consolidation in the farming sector with large farms buying up the smaller farms, causing a rotation of the type of equipment needed from smaller rigs, to the mega tractors, but with lower quantities of tractors being sold. This explanation is the argument we heard during our channel checks.

II. Energy: Petroleum, Natural Gas and Heating Oil

Energy next to Agriculture, from the perspective of the U.S. Department of Labor Producer Price Index report has dominated this report for several years. For the past few years the price of energy which includes crude oil, gasoline, or natural gas, has dominated this report. We have written extensively on this issue, concentrating on the crack spread (*Ibid*).

The area that appears of interest in this report is that of, heating oil, and natural gas to electric utilities prices which are up 29.5% and 22.2% y/y respectively. With gasoline prices hitting \$3.13 a gallon this week, the upcoming winter of 2008 will be very interesting for the consumer, particularly with both gasoline and heating oil's at these elevated levels. The question to watch is whether the elasticity of demand for gasoline is more elastic as the price goes above \$3.00 per gallon, and if not will the consumer cut back on purchases simply to heat their house and drive to work. Will we finally see a reduction in consumption by the consumer resulting from the high cost of energy, and are we at a critical juncture for the consumer at these prices.

III. Nonferrous Metals – Copper wire for Cogeneration Equipment

Nonferrous metals have been the real surprise in the November report with nonferrous wire and cable increasing 4.3% m/m, a consequence of the increase in high grade copper. We believe that much of this is going into building both domestic and international. We have written about the stable nature of total construction with private nonresidential making up for the gap in the slowdown in residential construction (*SISR, Dollar Likely to Strengthen against Major Currencies: Looking for Banking and Brokerage Rebound*, November 7, 2007).

Copper and copper alloy wire & cable, bare & tinne is up 22% y/y and up 14.2% m/m. Copper wire in addition to construction is used extensively in electrical generators. Turbines and generators were the surprise of the factory orders report this month with shipments increasing 22.2% m/m, and new orders increasing 21.9% m/m. Much of the growth in turbines and generators is believed to be in the area of energy cogeneration equipment. The nonresidential building sector is still growing with more and more commercial building using backup energy systems and cogeneration systems for both heating and conservation.

IV. Wastepaper and Wood Pulp – Recycled Paper being Exported

Wastepaper is up 64.8% y/y and 4/8% m/m and Woodpulp is up 12.9% and 0.6% respectively. Much of this paper is going to export with export prices up nearly 71.2% y/y on wastepaper. The wastepaper phenomenon is much like the pattern that we have seen with respect to steel, and copper, with the recent expansion in China and India placing large demands on raw materials like iron ore, and nonferrous metal ore, as crude materials necessary to make steel and refined copper. In this instance we are seeing

the raw material being wastepaper which is used for paper or more correctly recycled paper in various countries.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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