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Farm Economic Boom Nearing Top

Summary:

We are calling for a major top in the entire Agricultural Sector due to the decline in the price of Ethanol and transportation bottlenecks. This includes the Agricultural Chemical and Agricultural Equipment Sectors. In recent weeks the price of Ethanol has hit a multiyear low of $1.55 per gallon, down from a high of $2.57 in June of 2006, and $1.80 in June of 2007. This decline in the price of ethanol has lead to plans for new facilities to be delayed and even scraped. Much of the disjuncture has resulted from bottlenecks in the transportation system, of getting ethanol from the agricultural heartland to the two coasts where the major refineries are located.

The ethanol boom began with the Energy Policy Act of 2005 which mandated that the market consume 7.5 billion gallons of ethanol a year by 2012, in contrast to 3.5 billion gallons in 2004. This set off a 70% price increase in the price of corn, which in turn lead to record acreage being planted. The early beneficiaries of the increase in corn planting and price increases were not only farmers, but the entire agricultural sector, except ironically for the ethanol companies.

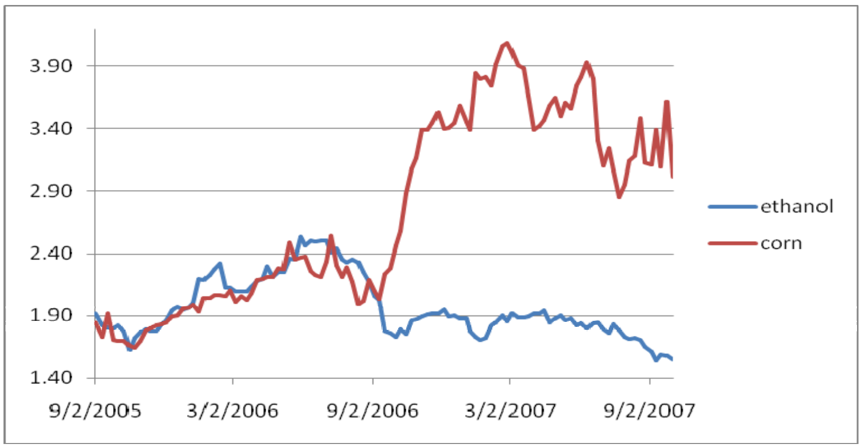
The entire agricultural sector as a result has been one of the best performing sectors in the economy over the past year. Some of the Agricultural Chemical Companies equity prices have appreciated as much 400% in the past year, particularly the chemical fertilizer companies like Potash Corp. of Saskatchewan Inc. (POT) The Mosaic Company (MOS), and Agrium Inc. (AGU). Similarly the Agricultural Machinery companies like Deere & Company (DE) and Agco Corp (AG) have nearly doubled in stock price. Even the railroad companies such as Burlington Northern Santa FE Corp. (BNI), Union Pacific (UNP), and Norfolk Southern Corp. (NSC) have generated tremendous interest especially since Berkshire Hathaway announced its investment in railroads, presumably due to the expectation of ethanol being transported via railcar.

However, with the decline in the price of ethanol, it is likely that the acreage of corn to be planted in the 2007-08 season is likely to decline, leading to a decrease in the amount of chemical fertilizers being demanded, as well as, a slowdown in the growth of agricultural equipment. **WE ARE PROJECTING THAT THIS BOOM IN AGRICULTURE IS NEARING ITS END. We expect this earnings season to show record earnings, but following this quarter we expect flatter rates of growth.**

I. Ethanol Spurs Agricultural Boom and Possible Thaw

The Energy Policy Act of 2005 was signed into law in August 8, 2005 increasing the amount of biofuel that must be mixed with gasoline sold in the United States from 3.5 billion gallons in 2004 to 7.5 in 2012. At the time of the act became law the price of ethanol was trading in the $1.90 to $2.00 range, with a major spike occurring during the year following the enactment of the energy bill of 2005. The price of ethanol hit a record high of $2.55 in June of 2006 only to decline to $1.50 within the year due in part to the oversupply of ethanol from the tremendous ramp up in ethanol plants and transportation bottlenecks.

Chart I: Comparison of the Price of Ethanol and Corn 2005 to 2007



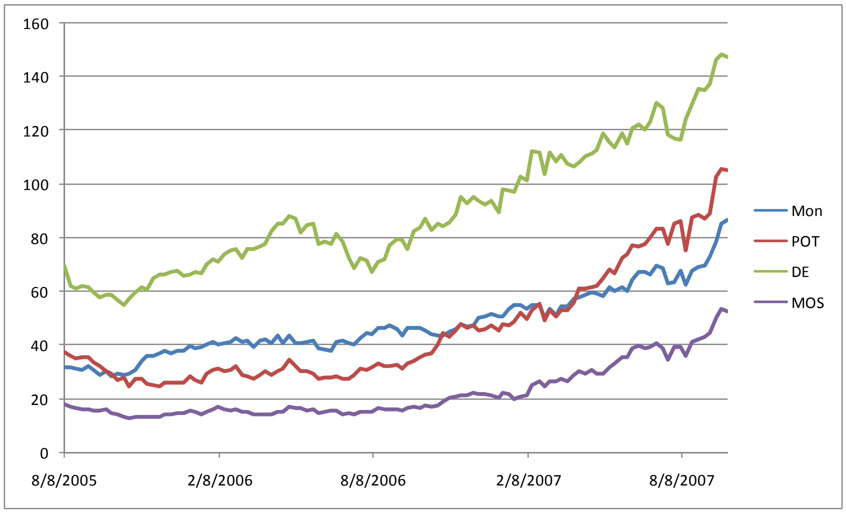
Source: Commodity Research Bureau

The price of corn alternatively followed an almost inverse pattern with the buildup of plants there was an increase of demand and farmers planted record acreage in 2006, with a projection of a 14.2% increase for 2007. This record planting was largely a consequence of the high price of corn relative to the other crops.

II. Boom For Fertilizer, Seed and Agricultural Equipment Makers

This increase in the planting of corn lead to one of the biggest booms for the fertilizer companies in more than a generation. The stock price of Mosaic, Potash, Monsanto, Deere, have appreciated by more than 100% in the last year. Each of these companies is having a record year. With respect to the fertilizer companies do in part to the rapid increase in demand, there was a record price increase of over 40% for Phosphate fertilizer in the last 6 months alone and last year a 30% increase in the price of Potash fertilizer, that helped the bottom line of these companies significantly.

Chart II: Stock Price for MON, POT, DE, MOS from August 2005 to Present



Source: Reuters

The current question however is will this trend continue? We believe it is near it current peak and we are projecting an underperformance for the industries of Agricultural Chemicals, and Equipment, resulting from a significantly slower growth rate.

III. Ethanol Companies Struggled During the Past Year

The very companies that the law was supposed to help, ironically, had perhaps their worst year ever. Looking at the four dominant ethanol companies: Archer-Daniels-Midland Co. (ADM), Verasun Energy, Corp. (VSE), Aventine Renewable Energy Holdings, Inc. (AVR), and Pacific Ethanol Inc. (PEIX); each of these companies are down over 60% in the last year, with the exception of Archer-Daniels which is more diversified than the others and down only 30%. With the price of corn at record highs and the price of ethanol declining these declining stock prices should not be that surprising.

Chart III: Stock Price for ADM, AVR, VSE, PEIX from August 2005 to the Present

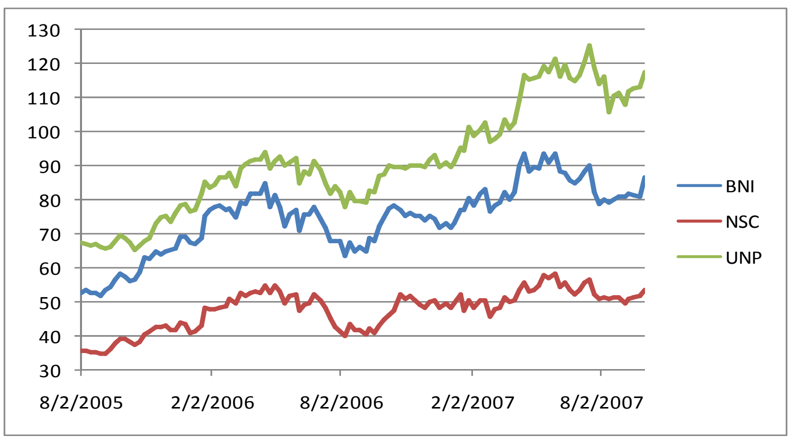
Source: Reuters

The question of interest is what will be the future prospects for ethanol and the entire farm industry. **We believe the ethanol companies will continue to struggle until there is equilibrium between: 1. demand and growth, and 2) the ability to get product to the market.**

IV. Railroad May See Same Growth as Agricultural Chemical, Supplies, and Equipment

In March 2007, Berkshire Hathaway (BBK.A) made significant headlines with the fact that they had taking large position in several railroad companies: Burlington Northern Santa Fe (BNI), Norfolk Southern (NSC), and Union Pacific (UNP). The immediate response was for these companies to surge in price, despite weak earnings, and the expectation that the economy was getting weaker. The obvious question was why now, and the obvious reason was the expected increase in ethanol transportation via the railroad.

Chart IV: Stock Prices of BNI, NSC, UNP from August 2005 to the Present



Since the Hathaway announcement the price of these railroad companies have basically underperformed the overall market. The question here being will the bottlenecks in transportation come to an end and will the ethanol traffic in subsequent months or years significantly help these rail companies in the future. **We believe that at this juncture the rail companies may well become the primary beneficiary of the expansion in ethanol production in the forward period.**

V. Likely Top for Agricultural Chemical, Suppliers, and Equipment

The conditions that helped the agricultural chemical and equipment companies to have major growth in the stock price over the past year appear to no longer exist. With the decline in the price of ethanol, and the bottlenecks in the transportation of ethanol we have already seen major changes in the expansion plans for ethanol plants, resulting in the termination and slowdowns in the expected growth of these facilities. In addition the price of corn has receded back to a level where explosive growth in planting we believe will be stabilized or even decrease. The price of Phosphates is up over 40% this year, and the price of Potash was up over 30% last year, an increase that is not sustainable.

If the fertilizer companies do not have pricing benefits and/or increased demand due to the stabilization in the corn crop, it is difficult to see how these companies can sustain their rates of growth, and the expanded forward looking price earnings ratios. **We expect that these fertilizer companies, and farm equipment companies, will report record profits this quarter, but will begin to pull in their forward guidance to a more modest rate of growth, causing their stock prices to come closer to market perform at best, and perhaps even underperform as we expect.**

VI. Risk Consideration

We have covered many sectors, using one variable ethanol to project their future performance. This is a risky undertaking in the best of circumstances. We have pursued this approach, because we believe that the 2005 Energy Bill, as is common with any government mandate, that market disequilibrium is likely to result. This disequilibrium sometimes occurs in ways easily anticipated, and other times, as with the ethanol companies it is more difficult to understand. We continue to pursue our model from the perspective that political events often influence economics, and the economics of these events will influence the equity prices of companies.

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1 – Recommended List – The stock has our highest recommendation and is expected to outperform the average equal weighted expected total return of the overall Market irrespective of sector. Our investment horizon is 12 – 18 months except as specified by the reporting analyst.

2 – Overweight – The stock is expected to outperform the equal weighted expected total return of the sector coverage. Our investment horizon is 12 – 18 months except as specified by the reporting analyst.

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2 – Positive – The sector fundamentals and valuations are improving with a positive second derivative.

3 – Neutral – The sector fundamentals and valuations are flat with the second derivative close to zero or with a neutral slope.

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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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