



TAG CATALYSTS

What We're Watching

- > **Grains:** European weather conditions have assumed lead importance this summer on extended heat and drought. Such conditions have driven recent CME grains price strength, but global wheat inventories remain robust and as such, prices are unlikely to reach the highs of 2008.
- > **Cotton:** Consistent with our views expressed last month, cotton prices have declined amidst positive crop conditions. Industry sources also suggest that yarn inventories may be building in China.
- > **Dairy:** Uncertain near-term global growth prospects have temporarily moderated upside price risks for milk powder. However, cheese prices are rising and consistent with our expectations for inflation this summer.

July 2010

FOOD COMMODITIES MONTHLY

TAG FOCUS

This month, we highlight the strong growth and trade-up potential of the global coffee market. Particularly in the U.S. and Western Europe, regions perceived as mature, opportunities are robust for consumers to trade into premium varieties. Elsewhere, the future is bright for both pure volume growth and trade-up in Latin America, Eastern Europe, and Asia. In our view, one of the best ways to participate in this secular trend is through shares of Sara Lee (\$15.24; 12-month price target: \$17-\$19). The company's broad portfolio is comprised of both mainstream and premium varieties, with new innovation and geographic expansion poised to deliver long-term growth.

In our view, the global coffee market offers investors one of the brightest, but maybe most overlooked, secular demand growth themes across the agricultural commodity universe. Global retail coffee is an estimated \$50 billion market on consumption of roughly 132mm 60-kilogram bags (approximately 8mm MT). In volume terms, global coffee demand expanded at a 2.6% CAGR over the 2000-2009 period and a much sharper 4.5% when excluding the more mature U.S. and E.U. geographies. Considering that many investors are most familiar with these two markets, it is unsurprising that coffee's long-term growth potential may not be fully appreciated by the investment community (U.S and EU per capita demand growth of 0.6% compares to 3.2% elsewhere). Further, even in mature economies where volume growth is less buoyant, we highlight the strong "trade-up" potential as consumers migrate up the value chain into premium and specialty coffees – with potentially large opportunities for at-home coffee producers.

A key differentiating factor driving secular coffee demand growth is the expanding support of governments and growers organizations in producing countries. Beholden for decades to exports and the booms and busts of the global coffee cycle, aggressive efforts are underway to leverage local disposable income growth to drive greater demand. Such a strategy may moderate the historical volatility and improve local farmers' living standards. Further, specialty coffee chains such as Starbucks, Illy, Tchibo, and Café Coffee Day are expanding into emerging markets and offering premium and specialty coffees to many consumers for the first time. These retail outlets are not only shouldering a meaningful portion of the investment necessary to educate consumers (otherwise borne by manufacturers such as Kraft and Sara Lee), but these investments are also accelerating consumers' interest in the premium, at-home segment.

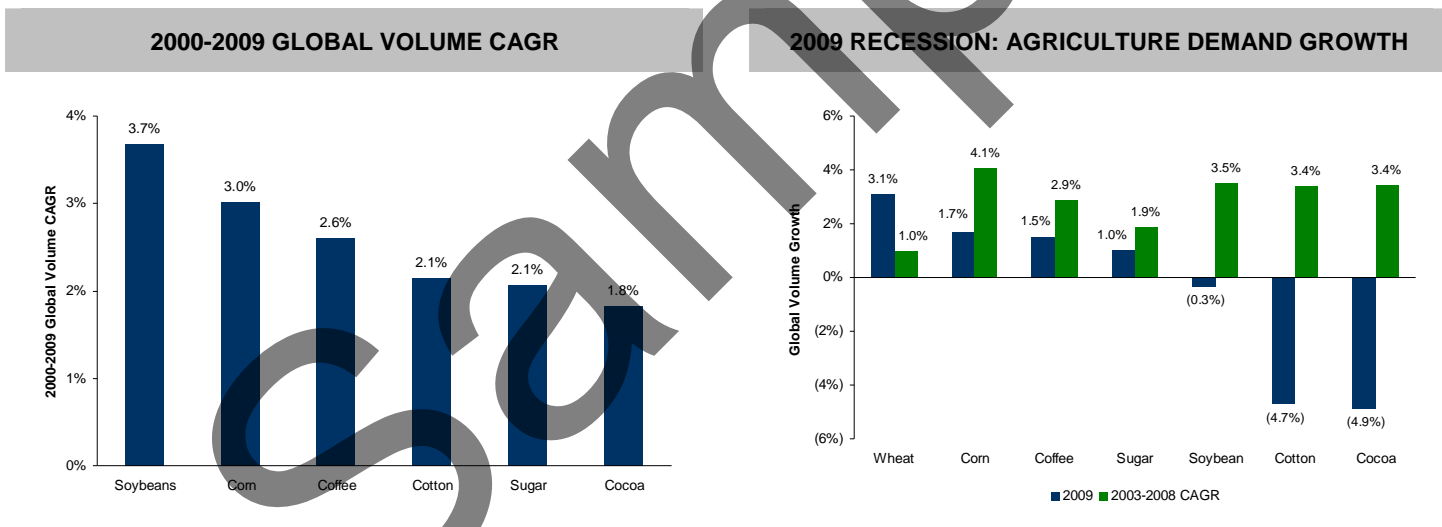
John J. Baumgartner, CFA
212.584.4624
jbaumgartner@telseygroup.com

I. TAG FEATURE FOCUS – THE SECULAR GLOBAL COFFEE OPPORTUNITY

A common theme across many commodities is demand growth coincident with disposable income growth and particularly across emerging markets. Although meat, dairy, and cocoa are frequently associated with such dynamics, we regard coffee as integral to any discussion of secular commodity demand. In our view, North American and European-based investors are most familiar with their local coffee markets – which exhibit a more mature, slower-growth volume trajectory. As such, it is unsurprising that other geographies, offering superior growth potential, may be overlooked by many Food and agricultural commodities investors. This month, we highlight secular coffee demand opportunities from three perspectives: volume growth, consumer “trade-up” into premium and specialty varieties, and the shift towards a “premiumization” of the retail coffee aisle. We also discuss our outlook for coffee commodity prices as our expectations for demand growth intersect with biological lags in supply response.

> **Global Coffee Demand: A Bright Outlook for Secular Volume Growth**

From a macro perspective, coffee’s 2.6% global volume CAGR over the 2000-2009 period is superior to other soft commodities including cotton, sugar, and cocoa. Further, coffee’s demand growth only modestly trails that for corn and soybeans which have uniquely benefited from government-mandated usage requirements as biofuel feedstocks. We also highlight coffee’s recent outperformance during the Great Recession – not only did it exceed the market’s expectations for its own performance, but also outperformed many of its agricultural peers. This may surprise investors familiar with Starbucks’ disappointing sales and broader Away-from-Home food traffic challenges during the downturn. However, we stress the resiliency and flexibility of coffee demand as it relates to At-Home consumption opportunities during periods of economic weakness.

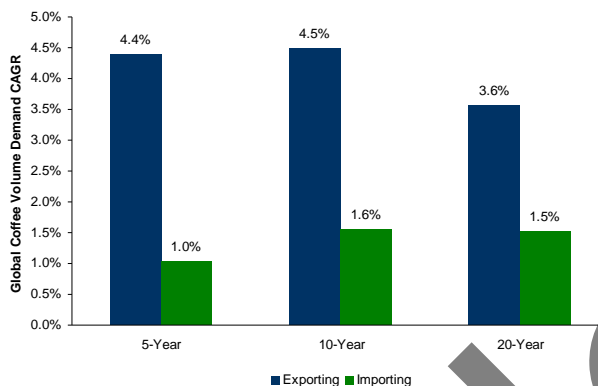


Source: Industry reports, TAG research and estimates

Source: Industry reports, TAG research and estimates

Although such a high level analysis is useful, it fails to fully explain the demand drivers unique to coffee – as well as our confidence that the category will maintain its attractive growth in the future. Expanding our discussion, we highlight the disparity of demand growth between producer/exporter regions such as Brazil, India, Vietnam, and Central America and traditional importers (the U.S. and E.U.). Specifically, demand in exporting countries has grown at a strong 4.5% rate over the 10-year period through 2009 relative to the much smaller 1.6% advance posted across importing regions. Growth of disposable income has clearly been a catalyst behind producing countries’ outperformance, but we regard government and industry-sponsored consumption programs as a more meaningful driver.

COFFEE DEMAND: EXPORTERS VS. IMPORTERS

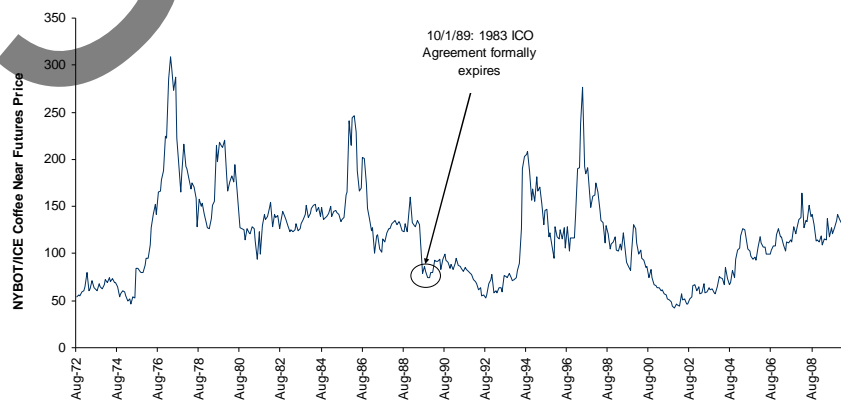


Note: Estimated CAGRs through 2009
Source: Industry reports

A brief reflection on the global coffee market’s turbulent history is helpful in grasping the unique structural drivers supporting today’s producer-led demand growth. Specifically, Brazil dominated production at the beginning of the 1900s with an estimated 75% global share and its Instituto Brasileiro do Café, a growers’ organization, coordinated prices via the stockpiling (and occasional destruction) of excess beans during periods of oversupply. The system worked well at the outset, but such price supports also benefitted producer economics in Colombia and supply increases inevitably weighed on global coffee prices. The pattern would later repeat when a larger coordination, this time between Colombia and Brazil in the 1930s, again enhanced industry profitability and spurred production in regions ranging from Central America to Africa and Asia, pre-World War II.

Following WWII, stronger coffee prices encouraged yet another round of increased plantings in Africa and subsequent price softness eventually led to the creation of the International Coffee Organization and the International Coffee Agreement (ICA) in 1962. The system assigned quotas to producing and consuming countries in an effort to balance supply and demand and was re-negotiated at various multi-year intervals. Although the agreement worked well at the outset (coffee prices held at levels above \$1.00/lb.), even the ICA withered under the weight of global pressures. Specifically, rising production from non-ICO members and a general evolution towards a free market philosophy led to the abandonment of the quota framework in 1989. In its wake, prices dropped to levels not witnessed in decades as Vietnam flooded the market with generally lower-quality Robusta beans.

MONTHLY NYBOT/ICE NEAR COFFEE FUTURES PRICES



Note: Cents/lb
Source: Bloomberg

Shifting to more recent trends, disposable income growth across emerging markets is driving demand for higher quality and more expensive products. As a number of these markets are also coffee producers, governments and local industry organizations are seizing on the opportunity to expand domestic coffee demand and in turn, moderate the historical reliance on trade to support local coffee farmers. At the core of this strategy is Brazil – the world's leading coffee producer with roughly 50% share of the Arabica market and 40% of the total market. As summarized below, the Brazilian Coffee Roasters Association (ABIC) and the Brazilian Coffee Fund (FUNCAFE) have emerged as critical drivers of domestic coffee demand. In addition to aggressively targeting consumption in younger demographics, efforts have also been made to grow consumption of premium coffee among older consumers. The success of Brazil's policies are clear – between 1990 and 2008, per capita coffee demand expanded at a 3% CAGR relative to the EU's 0.6% and the U.S.' 0.1% contraction. Brazil has also accounted for over 50% of global coffee consumption growth during the past decade.

BRAZILIAN COFFEE DEMAND PROGRAMS: A SNAPSHOT

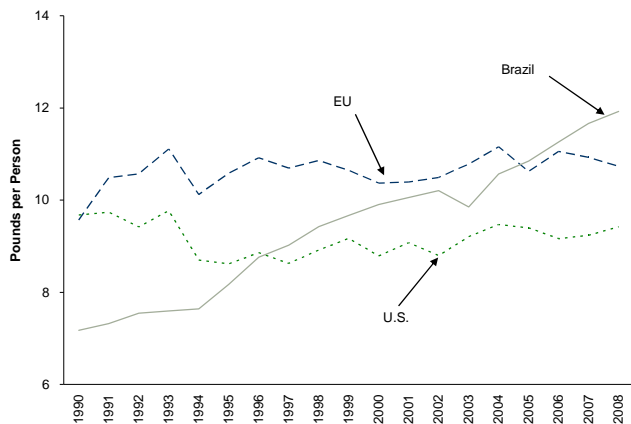
Strategic Approach	Target	Details	TAG View
Demographics	"Under-15" Age Group	Brazilian Coffee Roasters Association (ABIC) executes its "Café na merenda, saúde na escola", or "Coffee in School Meals, Health at School" marketing program. In concert with grower and roaster cooperatives, stresses coffee's perceived benefit on concentration and learning. Also includes daily servings of coffee and milk-blended beverages to schoolchildren as young as five years old. Industry estimates that the "under-15" demographic represents 15% of the market and as such, coffee/milk blends may be a strong gateway to cappuccinos and other coffee products.	The program possesses the potential to deliver both increased per capita consumption and broader long-term volume growth from a new generation of consumers.
Demographics	"15-and-Older" Age Group	Coffee and health campaign launched in 2008. Utilizes television, internet, and magazines to spread the awareness of coffee's energy and health benefits. Brazilian Coffee Fund (FUNCAFE) and local producers have aggressively invested to promote national consumption via quality improvements and raising awareness of the importance of the coffee industry throughout Brazilian history.	Scientific research increasingly points to perceived health benefits from coffee consumption and throughout Asia, functional coffees are becoming popular. FUNCAFE's strategy seeks to appeal to consumers interested in variety and health and wellness, along with making a somewhat patriotic case for coffee consumption.
Product Quality	Premium Offerings	ABIC is focused on developing the high-end coffee market. Marketing efforts target both the in-home and out-of-home channels. In addition, premium products are complemented by higher-priced innovation including coffee liqueurs, coffee shakes, and functional coffees.	Our sources estimate that 95% of Brazilian coffee consumption is derived from the "traditional" segment at prices of U.S. \$2.50/lb. relative to the 5% within the gourmet and premium sub-segments at U.S. \$3.50-8.50/lb. Industry targets a mix shift towards 15% premium consumption by 2015 and early results are encouraging -- annual specialty coffee growth is running 15%.

Source: Company reports, industry reports, TAG research

The International Coffee Organization has wasted little time in transferring Brazil's template to other producing countries via its "Step-by-Step" guide to consumption growth. At present, emphasis is concentrated on the "BIICs" – Brazil, India, Indonesia, and China which comprise 43% of the global population, but only 18% of coffee consumption. The Organization is targeting a consumption share of 25% by 2020 and what's positive, hot beverages are already popular (tea) and Western culture is favorably regarded – two likely supports for future coffee demand. Success is already evident in India where its 6% consumption CAGR over the 2000-2008 period is triple the 2% rate posted during 1951-2000.

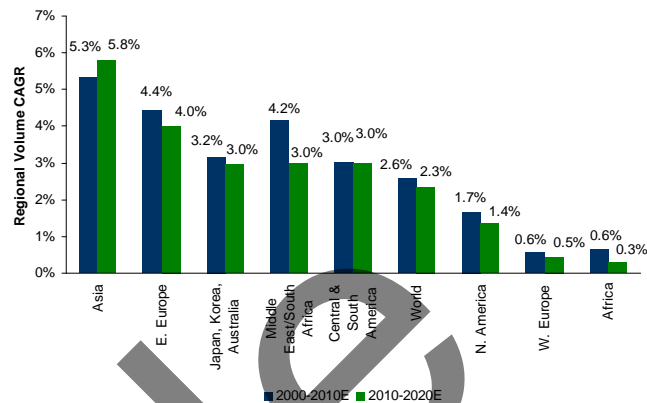
As depicted, we estimate aggregate global coffee demand will rise at a 2.3% CAGR during the 2010-2020 period relative to an estimated 2.6% rate during 2000-2010. Although a modest deceleration is expected, it is largely driven by a 20bp deceleration in population growth. By contrast, we expect the combination of ICO efforts and natural growth of the global middle class (both within and outside coffee-producing countries) to largely maintain recent per capita growth rates. Asia will likely prove the standout in terms of growth acceleration, but Central & South America, Eastern Europe, and Japan/Korea/Australia are also expected to remain relative outperformers.

1990-2008 PER CAPITA COFFEE CONSUMPTION



Source: Industry reports, TAG research and estimates

REGIONAL COFFEE VOLUME GROWTH ESTIMATES



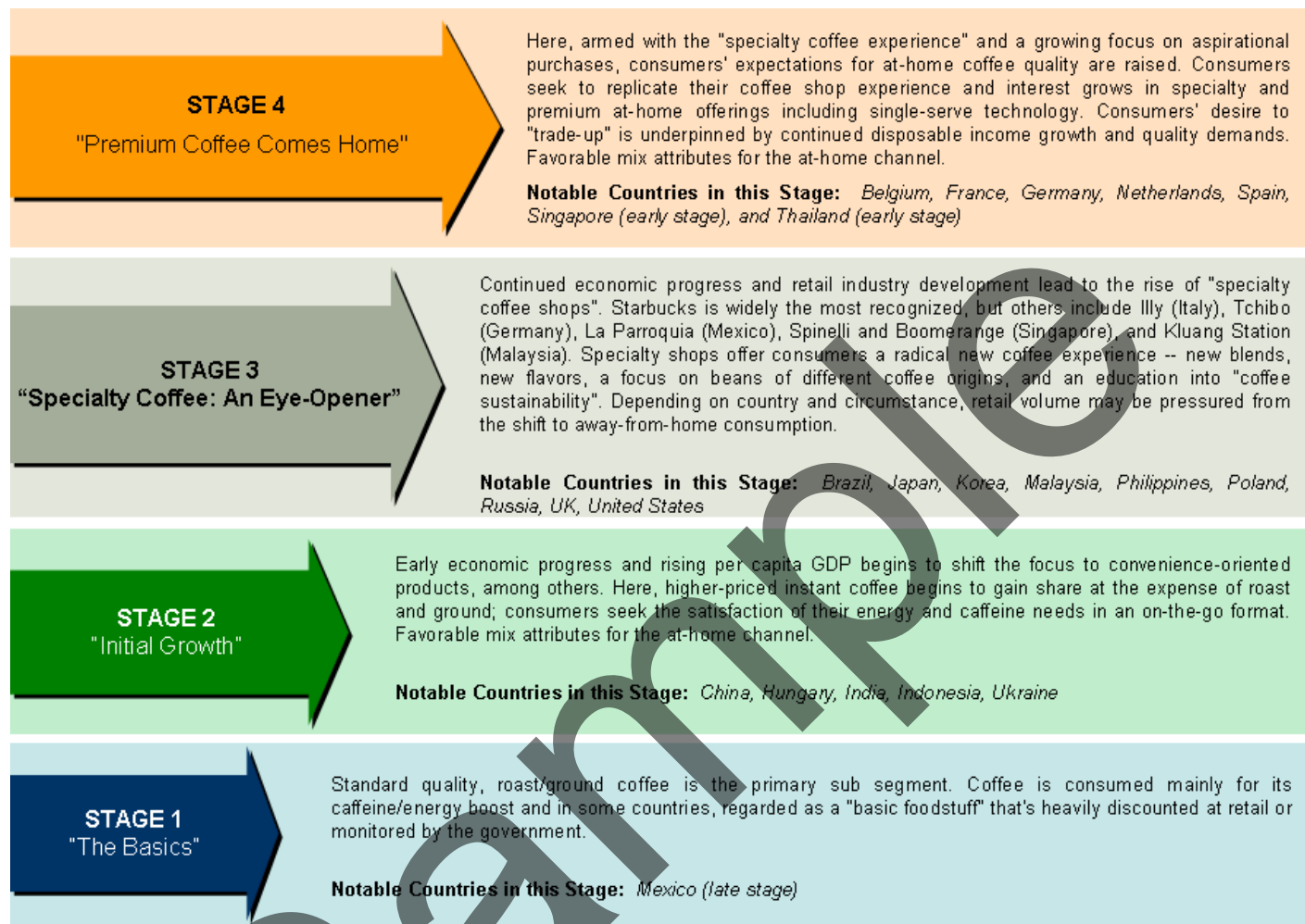
Source: Industry reports, TAG research and estimates

> **Global Coffee Demand: Strong Potential for Consumer “Trade-Up” in Mature Markets**

In our view, the bright prospects for global coffee volume growth over the next decade are augmented by opportunities for consumer “trade up” into premium and specialty varieties. We expect such a trend to occur within both developed and emerging economies, and driven initially by the expansion of specialty coffee chains in the Away-From-Home sector. Further, we believe that Away-From-Home premium coffee growth will be quickly followed by increasing demand for premium At-Home offerings – with retail selections evolving to meet consumers’ demands. To better convey our long-term thesis, we highlight our TAG Packaged Food Global Coffee Evolution Model which segments coffee demand into four stages. The model begins with Stage 1: “The Basics” in many low-income markets where lower-quality coffee is consumed mainly for its energy benefits. Consumers’ purchasing power in Stage 1 is limited and precludes opportunities to introduce premium coffee. In Stage 2: “Initial Growth”, initial disposable income growth and economic progress begin to drive demand for convenience-oriented consumer products and basic instant coffee increases in popularity. Stage 3: “Specialty Coffee: An Eye-Opener” marks the key inflection point in coffee demand evolution. Here, disposable income reaches levels sufficient to allow consumers an opportunity to purchase more premium products and coffee is a direct beneficiary. As specialty coffee shops such as the U.S.’ Starbucks, Italy’s Illy, and Germany’s Tchibo expand into these markets, consumers are introduced to a new coffee experience featuring unique blends and formulations. India’s own Café Coffee Day is among such participants and forecasts an expansion of local retail coffee outlets from just a handful in 2000 to nearly 4,500 by 2015.

The most advanced stage, “Stage 4: “Premium Coffee Comes Home”, is typically made possible from the traction gained by Stage 3’s specialty coffee shops. Our research indicates that as consumers gain familiarity with more advanced coffee blends and differentiated formulations, they also become more interested in duplicating that experience within the home. While some consumers may be seeking a lower-priced substitute to pricier coffee house offerings (particularly during periods of economic weakness), others may simply be seeking an upgrade from their traditional drip coffee makers. Either way, opportunities are quickly increasing for premium coffee consumption in the At-Home sector.





TAG PACKAGED FOOD GLOBAL COFFEE EVOLUTION MODEL



Source: Company reports, industry reports, TAG research

Turning our focus to the expanding premium At-Home sub-segment, we highlight the growth of single-serve coffee pod systems. Among the benefits driving single-serve adoption are its emphasis of higher-quality and more diverse coffee varieties, reduced waste as traditional coffee pots are eliminated, and convenience (both in preparation and clean-up). Sara Lee was among the earliest participants with its 2001 launch of *Senseo* in the "mass" segment, while Nestle has established itself in the premium segment with *Nespresso* espresso capsules. More recent mass entrants include Kraft's *Tassimo* in the U.S. and Europe, and likely the most-recognized at present in the U.S. is Green Mountain Coffee's *Keurig*. *Keurig's* well-rounded flavor portfolio, broad retail availability, and a targeted distribution approach (in many cases, it has leveraged initial Away-From-Home distribution into eventual At-Home adoption) have driven robust growth in recent years. Single-serve presence tends to be highest in Western Europe (Sara Lee holds a commanding share) and although adoption in the U.S. has been slower than expected, the recent recession likely increased consumers' awareness of the single-serve coffee experience.

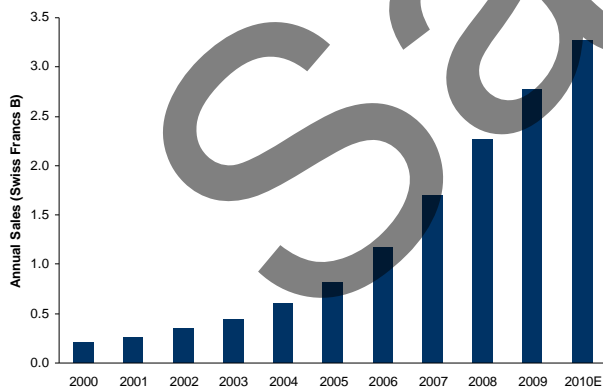
U.S. SINGLE-SERVE COMPARISON

Single-Serve System	Parent	Segment	Machine Price	8 oz. Coffee Cost
	Nestle	Luxury	\$200 – \$800	\$1.00
	Sare Lee Corp	Mass	\$50 – \$140	\$0.40
	Green Mountain Coffee	Mass	\$100 – \$250	\$0.40 - \$0.50
	Kraft Foods, Inc.	Mass	\$130 – \$200	\$0.60

Source: Company reports, Industry reports, TAG research

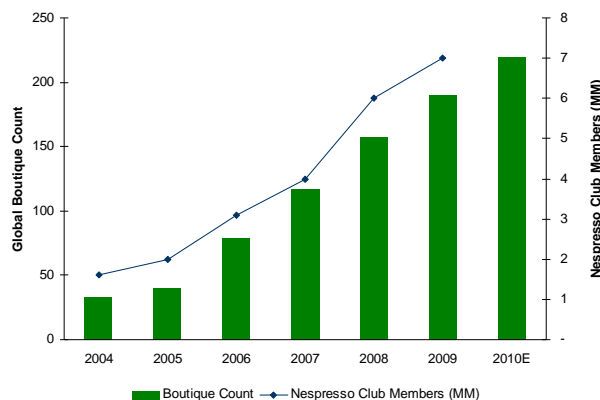
Nestle’s *Nespresso* may be the strongest indicator of At-Home single-serve growth potential. The company has heavily invested over the past decade to develop *Nespresso*’s premium aura and its position as an upscale, lifestyle product for sophisticated coffee drinkers. *Nespresso* features 200+ global boutique stores which market its espressos and also maintains an exclusive *Nespresso Club* registering seven million members. The brand’s success is clear – it posted a 35% CAGR from 2000-2008 and even in the Great Recession of 2009, sales grew 22% YOY to CHF 2.8 billion (or \$2.6 billion) on 9.6 billion capsules. We forecast 20% YOY growth in 2010 as 30 new boutique outlets are added in locations spanning Brussels to Munich, Miami to New York, and from Shanghai to Cape Town and Johannesburg. Nestle has also recently commissioned a new facility in Switzerland which raises its productive capacity by 4.8 billion capsules to meet forecasts for robust demand growth. Specifically, industry reports estimate that portioned coffee’s volume share of the global market is expected to rise from 3% in 2006 to 12% in 2015 (and from 7% to 25% in value terms).

NESPRESSO ANNUAL SALES



Note: Data in Swiss Francs (billion)
Source: Company reports, TAG estimates

NESPRESSO BOUTIQUE AND CLUB MEMBER COUNT

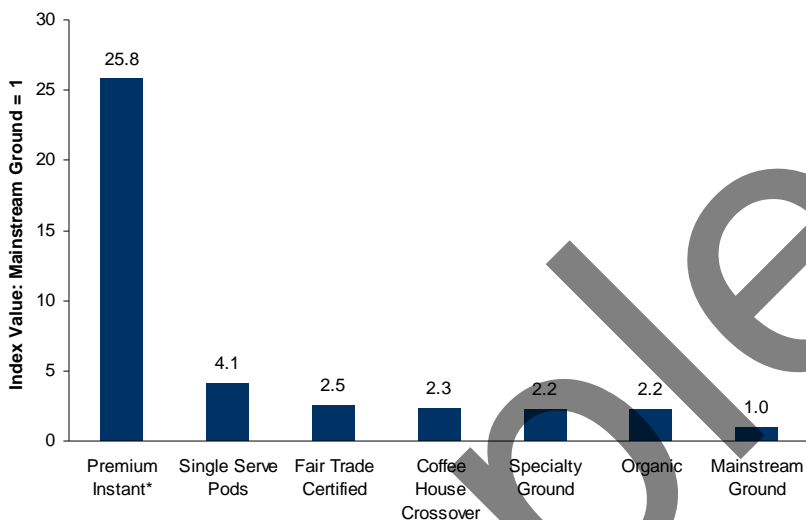


Source: Company reports, TAG research and estimates

In addition to the rising popularity of the single-serve sub-segment, the shift towards coffees of a premium variety has also occurred within the more traditional mainstream coffee arena. Specifically, among the more recent additions to the category are origin-specific and specialty roast & ground, whole bean, Fair Trade Certified, organic, coffee house crossovers (Starbucks and Dunkin’ Donuts), and even premium instant (new *Starbucks Via*). Below, we summarize the

retail price points of these sub-segments relative to the mainstream ground market. Clearly, the coffee aisle has undergone a “premiumization” in recent years and we expect little change to the trend going forward.

THE “PREMIUMIZATION” OF THE U.S. COFFEE AISLE



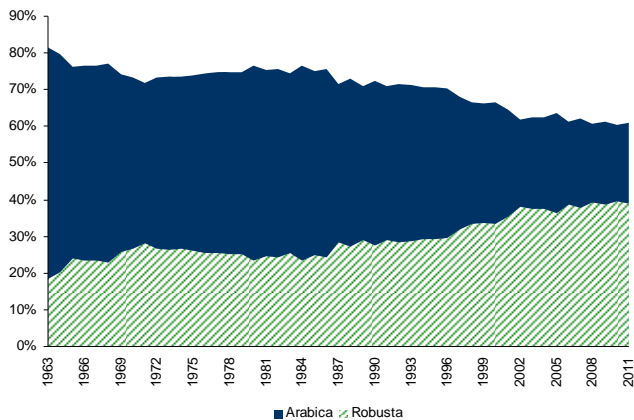
Note: Retail price of niche segments relative to mainstream roast. *Premium Instant reference is Starbucks Via
 Source: TAG research

> **Global Coffee Supply: Subject to Periodic Supply Tightness and Price Volatility, But Investments Being Made**

There are a number of coffee species in existence, but the well-known Arabica and Robusta varieties comprise nearly 100% of coffee consumed worldwide. Arabica beans are typically regarded as of higher quality and better flavor than the Robusta variety and are featured in premium and specialty coffees. Arabica beans maintain a 62% share of global coffee output, but its majority has steadily eroded over the past few decades given the sharp expansion of Robusta production in areas such as Vietnam. By contrast, Robusta trees are often higher yielding, but produce generally bitter-tasting beans featuring less flavor and a caffeine content roughly 50% more than that found within Arabica beans. Robusta beans are frequently used for instant coffee.

Arabica beans are predominantly grown in Central and South America, with Brazil commanding a dominant 47% share of global Arabica production. A meaningful portion of Robusta beans are sourced across Asia and Africa (Vietnam holds 34% share of the global market), but Brazil is also a leading producer. As depicted on an aggregate basis, Brazil holds a leading 38% share of global coffee production and is followed by Vietnam’s 14%, Indonesia’s 7%, Colombia’s 6.5%, and India/Mexico at 3.4%, respectively.

GLOBAL COFFEE PRODUCTION SHARE HISTORY



Note: Share of global coffee output: Arabica and Robusta, 3-yr rolling avg.
Source: Industry reports, TAG research and estimates

MARKET SHARE OF WORLD COFFEE PRODUCTION

Arabica Share			Robusta Share			Total Share		
Rank	Country	Share	Rank	Country	Share	Rank	Country	Share
1	Brazil	47.2%	1	Vietnam	33.9%	1	Brazil	38.3%
2	Colombia	10.6%	2	Brazil	24.4%	2	Vietnam	13.5%
3	Mexico	5.3%	3	Indonesia	15.4%	3	Indonesia	7.0%
4	Guatemala	5.0%	4	India	5.9%	4	Colombia	6.5%
5	Ethiopia	4.9%	5	Uganda	5.3%	5	India	3.4%
6	Peru	4.6%	6	Cote d'Ivoire	4.0%	6	Mexico	3.4%
7	Honduras	4.5%	7	Malaysia	1.9%	7	Guatemala	3.0%
8	Nicaragua	2.2%	8	Thailand	1.7%	8	Ethiopia	3.0%
9	India	1.9%	9	Philippines	1.1%	9	Peru	2.8%
10	El Salvador	1.8%	10	Cameroon	1.0%	10	Honduras	2.7%

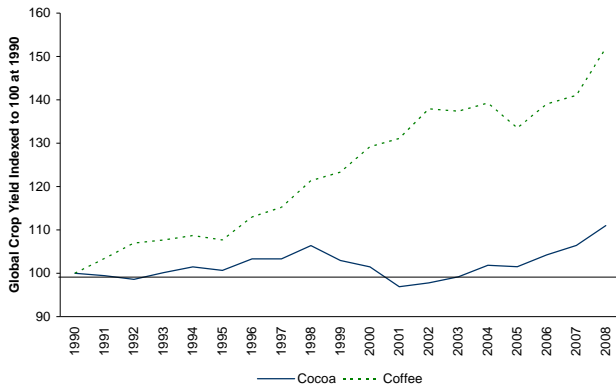
Source: Industry reports, TAG research and estimates

From a production perspective, coffee is susceptible to the typical risks related to weather (moisture and temperature) and crop disease. That said, the crop also features unique aspects such as being largely limited to the tropics and a delayed period for bean production – new trees typically do not produce fruit prior to the first 4 years of life and 6 years are required for a tree to reach maturity and full production (a tree’s useful life ranges from 20-25 years). In addition, coffee trees tend to exhibit biennial production cycles of heavier crops followed by lighter crops which are particularly noticeable in the production of Brazilian Arabica.

The biological lags associated with new coffee plantings suggest a risk of structurally higher commodity coffee prices given forecasts for steady coffee demand growth – and not dissimilar to our bullish structural thesis for cocoa prices. That said, we believe the coffee industry is relatively better-positioned to meet long-term demand growth on two accounts. First, the shorter lead time for coffee trees relative to cocoa clearly minimizes the timeline required for new production (5 years for an initial cocoa fruit harvest and 10 years to peak production). Second, and most important, we highlight the more favorable structural supports for new production in the coffee industry. In contrast to a cocoa industry adversely impacted by years of limited investment, coffee producers have been more proactive in terms of husbandry practices and re-plantings as they incorporate higher-density plantings, wider usage of fertilizers, and mechanized harvesting. Examples of structured support programs are those adopted in Central America where growers are encouraged to re-plant ageing trees with government-backed financial support and are also often offered low-interest financing or credits for the purchase of fertilizers and other inputs.

As depicted, the results of such efforts are clear – over the past 20 years, global coffee yields have risen 50% relative to the 10% advance posted by the cocoa industry and we have highlighted the yield performance of key Central American Arabica producers. In the wake of yield declines at the beginning of the decade, subsequent investment is now producing steady yield growth. Even in Brazil, where one could argue that local coffee yield growth is the product of a mix shift towards Robusta production, the country exhibited sharp yield advances even prior to increased Robusta plantings.

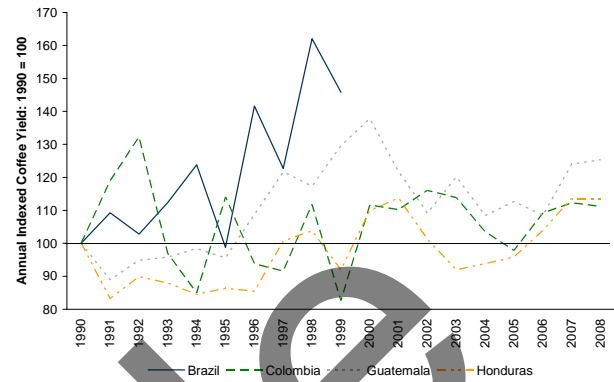
INDEXED YIELD PERFORMANCE: COFFEE & COCOA



Note: Indexed to 100 at 1990

Source: Industry reports

YIELD HISTORY OF ARABICA COFFEE PRODUCERS



Source: Industry reports, TAG research and estimates

In addition to yield improvements, opportunities for acreage expansion are also potentially robust. Specifically, industry estimates suggest that roughly 250mm acres of arable land remain untapped in Brazil alone for potential agricultural expansion – and a large portion is located in the cerrado region home to Brazil's quality coffees. Although environmental regulations may be encountered as planted area expands, we stress the point that potential land is available. In Colombia, an ambitious program seeks to expand production to 14mm bags by 2015 from the current 10mm as older trees are replaced.

Outside South America, strong Arabica production growth is already underway in areas such as Ethiopia, where public and private investment are expected to increase output from 350,000 tons in 2009 to 580,000 tons by 2014. In closing, we believe demand growth will support coffee prices over the long term and year-to-year variances in output will continue to augur transitory price spikes. However, the industry is likely equipped with the means of production to satisfy long-term global demand without triggering destabilizing structural price inflation.

> **TAG View: Long-Term Investable Global Coffee Opportunities**

In our view, the Packaged Food companies best-aligned with our secular long-term global coffee growth outlook are Sara Lee (\$15.24; \$17-\$19 12-month price target range), Kraft Foods (\$29.49; \$32-\$34 12-month price target range), and Nestle (uncovered), respectively. We regard Sara Lee as offering among the best prospects to participate in both secular volume growth and consumers' trading up into premium varieties. Specifically, Sara Lee maintains a portfolio of strong regional brands which drive leading share in Brazil (its *Pilao* grew 9% in 2009) and its *Maison du Cafe* and *Douwe Egberts* are well-established in Europe. Further, the company holds a dominant share of the European single-serve market behind *Senseo* and the recently-launched *L'OR* single-serve espresso capsule augments long-term premium opportunities. As highlighted in our May 11, 2010 initiation report, *L'OR* is positioned as a quality lower-cost alternative to Nestle's *Nespresso* and dissimilar to *Nespresso*, *L'OR* is sold in the mass retail trade. We believe *L'OR* will benefit from distribution advantages similar to *Keurig's* success in the U.S. and in addition, *L'OR* stands to leverage *Nespresso's* years of investment in cultivating the single-serve market and its aggressive global expansion strategy.

Kraft also offers investors exposure to the global coffee market, albeit a much smaller proportion of net revenue (roughly 8% relative to an estimated 36% at Sara Lee). The category is included among its "5/10/10" developing markets growth strategy and similar to Sara Lee, Kraft maintains a strong presence in the growing markets of Eastern Europe (Hungary, Czech Republic, and Poland). Further, the company holds strong share in Russia (a market in which Sara Lee has struggled to gain a foothold) and leading share in the UK and in Western Europe (Germany and France). Kraft has also actively expanded its *Tassimo* single-serve brand in the U.S. and Europe and features a marketing and distribution agreement for *Starbucks* coffee in the At-Home segment. That said, we also note larger relative potential competitive challenges for Kraft in the years ahead on two fronts. First, although Kraft has re-energized its *Maxwell House* brand in the U.S. behind a reformulation and packaging makeover, we believe it could face greater competition from the premiumization of the U.S. coffee aisle. Second, in the EU, Kraft is also exposed to meaningful private label coffee competition. Further, we regard Sara Lee as relatively much better entrenched in the European single-serve market given its early-mover advantage.

In closing, although Nestle falls outside our Packaged Goods coverage universe, it is still worth noting the company's well-established portfolio. Specifically, Nestle maintains a dominant share of the global instant coffee market behind *Nescafe* and also features brands in the mainstream and premium single-serve segments. In contrast to Sara Lee and Kraft, Nestle also maintains a meaningful presence across the growth markets of Southeast Asia (Vietnam, Thailand, Singapore), India, and Mexico. However, Nestle is not without its own challenges as Sara Lee and upstart Ethical Coffee Co. seek a foothold in the premium espresso capsule sub-segment.

II. MONTHLY AGRICULTURAL COMMODITIES ANALYSIS

This month, we assume a more bullish outlook on agricultural commodities prices through year-end on two factors. First, the rapid deterioration of weather conditions across the Black Sea region and Europe have been striking and threaten to materially weigh on global grain production this summer. We reiterate our view that global wheat inventories remain abundant and even after adjusting for lower output, prices are unlikely to near the highs of 2008. That said, lower output will limit the opportunity to further expand existing inventories – and now suggest prices above our initial expectations. Second, investment flows are increasingly likely to return to the agricultural commodities sector. Considering the uncertain outlook for the equities market and minimal yield availability across the fixed income world, investors are clearly looking for an investable theme and reports of tighter commodities supplies are likely to capture investors' attention. At this point, we believe that the majority of estimated crop losses are already priced into the grains complex, but price risks remain weighted to the upside until weather conditions improve.

JULY 2010 COMMODITY PRICE RECAP

Commodity	Closing Price			Change	
	7/31/2010	6/30/2010	7/31/2009	vs. Prior Month	vs. Prior Year
Corn (\$/bu)	3.93	3.54	3.40	10.9%	15.7%
Soybeans (\$/bu)	10.53	9.49	11.34	11.0%	(7.2%)
Chicago Wheat (\$/bu)	6.62	4.65	5.28	42.3%	25.2%
Cotton (cents/lb)	82.4	82.6	57.9	(0.3%)	42.2%
Cocoa (\$/MT)	3,091	2,894	2,892	6.8%	6.9%
Coffee (\$/lb)	1.76	1.64	1.28	7.4%	37.9%
Live Cattle (cents/lb)	92.7	91.3	84.7	1.5%	9.4%
Lean Hogs (cents/lb)	85.8	79.2	56.0	8.3%	53.2%
Soybean Oil (cents/lb)	39.8	36.3	35.1	9.8%	13.6%
World Sugar (cents/lb)	19.6	18.0	18.6	8.5%	5.2%
Cheddar Cheese (\$/lb)	1.56	1.40	1.26	11.4%	23.6%

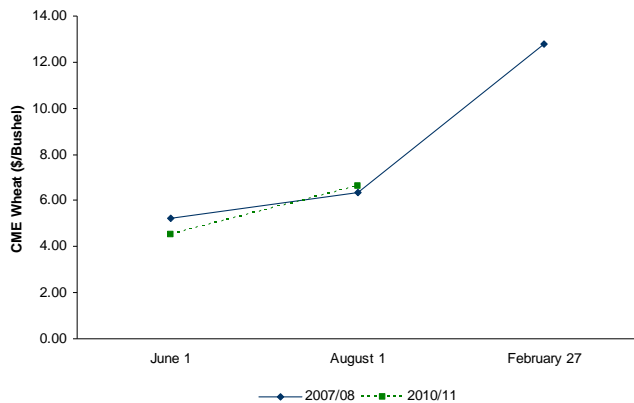
Source: CME, ICE

> GRAINS

The grains complex turned in a bullish July led by wheat price strength (the average July CME price rose 26% sequentially). Driving the increase is the striking speed of crop deterioration across Russia and the Black Sea region on oppressive heat and drought, along with expectations for a smaller crop in Canada after excess moisture this spring. As industry estimates for the size of Russia's 2010 wheat harvest are reduced daily to levels suggestive of a local production deficit (we have heard 2010 output may drop to as little as 45mm MT vs. last year's 62mm MT and relative to domestic demand of roughly 46mm MT), concerns are rising that Russia may limit exports if crop conditions remain stressed. As a reminder, Russia comprises 9% of global wheat output and a larger 13% of global exports. As such, an opportunity may arise for U.S. exports to fill any supply shortfall.

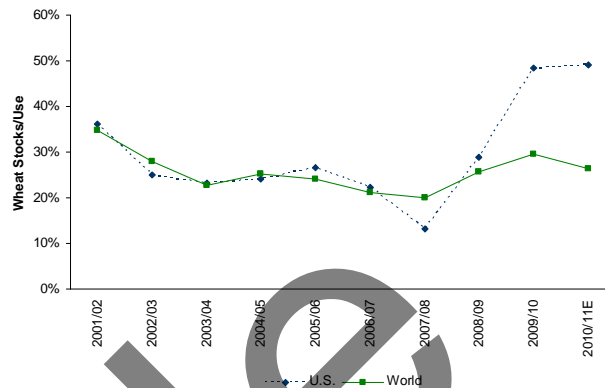
As depicted, recent CME wheat price activity reflects shades of 2007/2008 when U.S. exports rose 39% YOY to 34mm MT and pushed prices from \$5.20/bu on 6/1/07 to \$12.80/bu on 2/27/08. Given the current uncertainty over Russia's eventual harvest (and prospects do not appear favorable), we cannot rule out further wheat price increases. However, the odds of a repeat of 2007/2008 are limited on two accounts. First, an estimated 2010/2011 global wheat stocks/use of 26.4% (even accounting for a Russian crop at 46mm MT) is well above 2007/2008's 20.1% (the lowest in 40+ years) and larger beginning inventories serve as a buffer against the peak prices of the past cycle. Second, although 12mm MT of exportable supply from Canada and Russia may be removed from the market given this year's reduced output, prospects for stronger Southern Hemisphere production in Australia and Argentina may provide an offset of roughly 4.5mm MT. On the demand side, another notable difference between today and 2007 is the absence of incremental buyers such as India and Pakistan to drive prices higher – India is absorbing its largest inventory in nearly a decade and Pakistan may attempt to export a portion of its own surplus given limited grain storage capacity and robust government inventories.

CME WHEAT PRICE COMPARISON



Source: CME

U.S. AND GLOBAL WHEAT STOCKS/USE HISTORY



Source: TAG research and estimates

As such, we believe that current CME wheat prices are already pricing in a worst-case scenario where Black Sea supply is largely removed from the market and U.S. exports spike. The recent price strength has also been accentuated by the extremely bearish sentiment in the wheat market entering summer – the net short position was at its largest level in 4+ years. Should robust U.S. export expectations fail to materialize, or if the Russian crop does not further deteriorate, near-term U.S. export opportunities could disappoint and send wheat prices lower. Over the next few weeks, we expect wheat prices will remain volatile and predisposed to move higher as the market awaits greater visibility into Russia’s harvest prospects and export policy inclinations. As it relates to our Food coverage universe, wheat price inflation is clearly worth following given its importance as an ingredient. However, we believe that the prolonged period of wheat price weakness has afforded food manufacturers a solid opportunity to hedge at favorable rates. Consistent with this view, Kellogg raised its forecast for 2010E YOY COGS inflation to 4%–5% from the prior 3%–4% on its July 29th 2Q10 earnings call, but cited sugar and packaging as the key drivers (it also maintains a 90% hedged position for the remainder of 2010). We seek greater clarity on our companies’ wheat exposure over the next two weeks as Kraft reports 2Q10 EPS on 8/5 and Sara Lee reports Fiscal 4Q10 on 8/12, respectively.

Corn prices also posted a strong July with the average CME price up 8% sequentially. We attribute this to a combination of three factors. First, the USDA’s 6/30/10 annual *Acreage* report negatively revised 2010 U.S. planted corn acreage by 100bp relative to 3/31/10’s initial *USDA Prospective Plantings* estimate and also trailed market expectations – suggesting a modestly smaller harvest this autumn. Second, 6/30/10’s *USDA Quarterly Grain Stocks* report indicated a smaller than expected U.S. corn inventory as of 6/1/10 – suggesting tighter supply ahead of harvest. Finally, corn was also likely supported by a spillover effect from wheat strength. Similar to wheat, we expect corn prices will maintain a positive bias over the next few weeks given upside risks to export demand – partially from China and partially as a feed grain alternative to increasingly pricey wheat. That said, the U.S. crop remains in good condition (at 8/1/10, 71% of the crop was rated “Good/Excellent” by the USDA relative to 68% in 2009) and is developing ahead of schedule, while China’s corn crop is also looking good following a slow start to its growing season. In the absence of a material deterioration in either country’s crop, or material upside to U.S. wheat exports, upside risks to corn prices from current levels are likely limited. However, if wheat prices remain strong, we would not be surprised to see corn track towards the \$4.50/bu level, near term.

Rounding out the grains and oilseeds complex and consistent with its peers’ performance, average CME soybean prices closed up 6% in July. Soybeans likely found support from a similar combination of tighter than expected domestic inventories as of 6/1/10 and spillover support from wheat and corn. Soybean prices are also likely to directionally track corn and wheat over the next few weeks into harvest.

Recognizing the likelihood of stronger near-term grains prices, we are raising our 2010E corn price forecast to \$3.65/bu from \$3.53/bu prior, we are raising our 2010E soybean price to \$9.36/bu from \$8.99/bu prior, we are raising our 2010E

soybean oil price to 41.1 cents/lb from 38.9 cents/lb prior, and are raising our 2010E wheat price to \$5.51/bu from \$4.50/bu prior.

TAG 12-MONTH GRAINS AND OILSEEDS PRICE FORECASTS

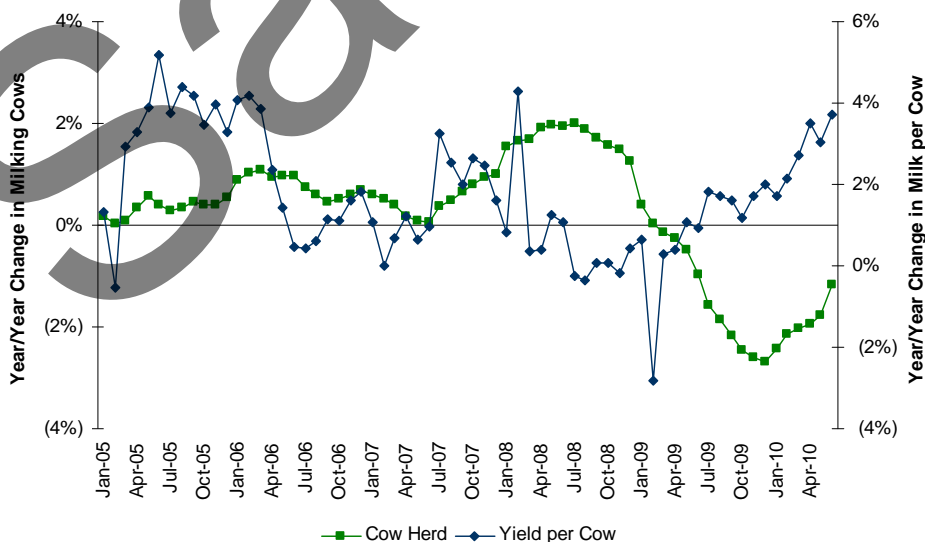
Commodity	TAG Quarterly Price Forecasts										TAG Annual Price Forecasts		
	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10E	4Q10E	1Q11E	2Q11E	2009	2010E	2011E
Corn (\$/bu)	3.77	4.06	3.26	3.85	3.71	3.55	3.63	3.70	3.95	4.11	3.74	3.65	4.09
Year/Year	(26.8%)	(35.5%)	(43.7%)	0.6%	(1.8%)	(12.6%)	11.3%	(3.8%)	6.4%	15.7%	(29.1%)	(2.4%)	12.2%
Soybeans (\$/bu)	9.45	11.27	10.53	10.01	9.50	8.93	9.72	9.30	9.65	9.78	10.31	9.36	9.71
Year/Year	(28.6%)	(18.8%)	(21.3%)	12.0%	0.5%	(20.8%)	(7.6%)	(7.1%)	1.6%	9.5%	(16.5%)	(9.2%)	3.7%
Soybean Oil (cents/lb)	32.5	37.3	34.9	38.1	38.6	38.1	41.4	42.2	42.2	41.7	35.68	40.09	42.41
Year/Year	(42.9%)	(38.9%)	(35.6%)	5.4%	18.7%	2.4%	18.7%	10.9%	9.3%	9.3%	(31.5%)	12.4%	5.8%
Wheat (\$/bu)	5.50	5.66	4.84	5.21	5.00	4.67	5.95	6.42	6.43	6.24	5.30	5.51	6.19
Year/Year	(46.0%)	(32.3%)	(38.4%)	(4.7%)	(9.1%)	(17.4%)	22.9%	23.2%	28.8%	33.6%	(33.4%)	3.9%	12.4%

Source: CME, TAG research and estimates

> **DAIRY**

We maintain our bullish outlook for dairy prices given our concerns over a potentially tighter near-term supply environment. As highlighted in past reports, current U.S. milk production is being driven by impressive yield growth which more than offsets the contraction of the national dairy cow herd. Specifically, the shift to a more productive cow base raised June's output per cow a robust 3.7% YOY (vs. a 90bp comp) and marked the third consecutive month of 3% or better yield growth. Although such performance has exceeded our expectations, growth is likely to soon moderate given the likely widespread heat stress associated with July's warm temperatures. In addition, resilient ground beef prices may support incremental dairy herd culling – amplifying any milk production moderation and price strength as school re-openings trigger demand recovery.

U.S. YOY DAIRY HERD AND OUTPUT PER COW CHANGE



Source: Industry reports

We expect potential weather issues to materialize in downstream products such as cheese in the form of a reduced supply of milk solids. Such a development has likely already been witnessed in market prices given cheese's 11% sequential increase in July and consistent with forecasts expressed in our May 14, 2010 Food industry initiation report. We reiterate our view that supply tightness is likely to support cheese prices into autumn, although rising prices may also weigh on sales – keeping prices well below the highs of \$2.20 reached in June 2008. It appears that a value-conscious consumer is already driving wholesale price hesitation – 2Q10's cheese PPI rose 12.5% YOY and contracted 30bp sequentially relative to commodity cheese price increases of 26% and 0.6%, respectively. As such, we anticipate Kraft Foods may announce 2Q10 U.S. Cheese segment margin pressure when it releases earnings on August 5th (7% of net sales and segment operating income, respectively). We are reducing our 2010E cheddar cheese price marginally to \$1.49/lb. from the prior \$1.50/lb. and see limited downside risks relative to our estimate – 3Q10 prices are likely to rise 26% YOY.

Turning to the powdered milk market, average July prices declined 6% sequentially but remain up 44% YOY. In our view, recent weakness has been driven by end demand uncertainty given slowing macro indicators in Asia and lingering excess European Union inventories. We are lowering our 2010E average price to \$1.18/lb. from the prior \$1.22/lb., but believe further downside risks are limited as demand gradually recovers. In particular, the EU's recent auctions of its powder inventory have failed at price levels equivalent to \$1.05-\$1.22/lb. – suggesting the international floor is near the U.S. price of \$1.19/lb. We continue to believe that Hershey's input cost structure will remain challenged during 2H10 and particularly by dairy costs which we forecast up roughly 30% YOY in 3Q10 and 2% in 4Q10, respectively. General Mills may also witness upward cost pressure in its *Yoplait* yogurt unit, but inflation may ultimately temper the category's modest price discounting which has persisted through June.

TAG 12-MONTH DAIRY PRICE FORECASTS

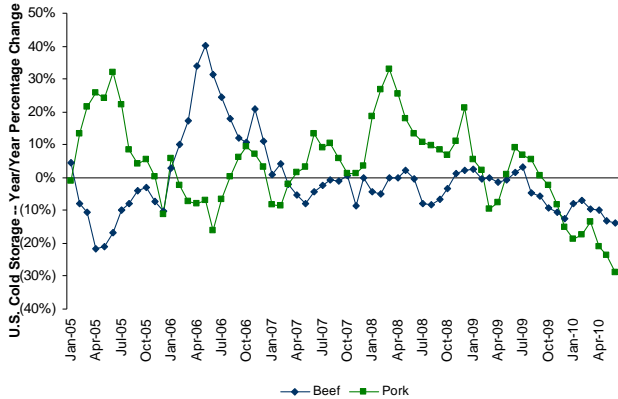
Commodity	TAG Quarterly Price Forecasts										TAG Annual Price Forecasts		
	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10E	4Q10E	1Q11E	2Q11E	2009	2010E	2011E
Cheddar Cheese (\$/lb)	1.19	1.11	1.25	1.46	1.38	1.39	1.58	1.60	1.59	1.61	1.25	1.49	1.61
Year/Year	(36.8%)	(43.9%)	(30.9%)	(12.5%)	16.3%	25.7%	25.9%	9.8%	15.3%	15.5%	(31.7%)	18.9%	8.2%
U.S. Class I Fluid Milk (\$/cwt)	11.96	10.47	10.41	13.07	14.74	14.10	15.63	15.85	15.51	14.84	11.48	15.08	15.23
Year/Year	(37.4%)	(41.2%)	(45.1%)	(18.8%)	23.2%	34.7%	50.2%	21.3%	5.2%	5.2%	(36.2%)	31.4%	1.0%
U.S. Nonfat Dry Milk (\$/lb)	0.82	0.83	0.90	1.16	1.12	1.24	1.18	1.18	1.18	1.21	0.93	1.18	1.25
Year/Year	(39.7%)	(36.3%)	(32.3%)	28.9%	36.3%	48.3%	30.8%	2.0%	5.4%	(1.9%)	(24.2%)	27.0%	6.3%

Source: CME, TAG research and estimates

> **LIVESTOCK/MEATS**

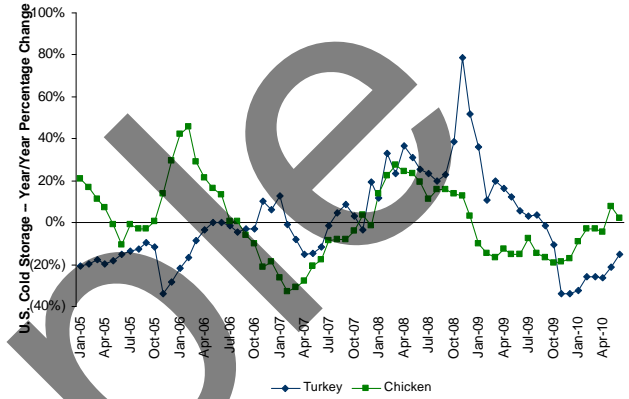
Average July CME Live Cattle and Lean Hog prices rose modestly in July (up 1.5% and 1.1%, respectively) as tight inventories and gradual demand recovery continue to support prices during the summer season. Specifically, U.S. June 2010 cold storage inventories declined 13.7% for beef (vs. a +1.6% comp), declined 29% for pork (vs. a +9% comp), rose 2.3% for chicken (vs. a -14.9% comp), and declined 15.3% for turkey (vs. a +5.7% comp), respectively.

U.S. MONTHLY YOY RED MEAT INVENTORIES



Source: USDA

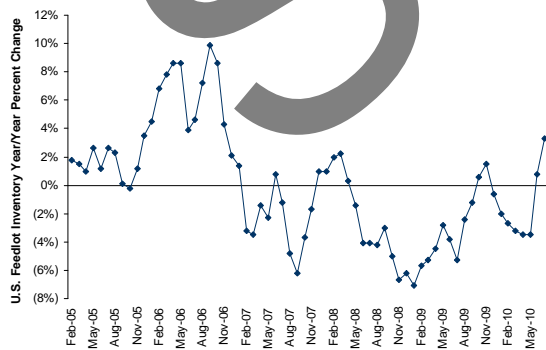
U.S. MONTHLY YOY POULTRY MEAT INVENTORIES



Source: USDA

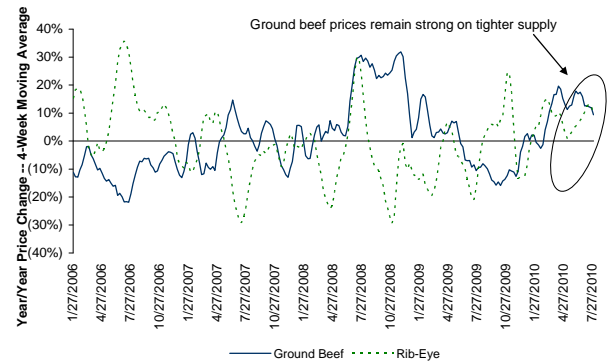
For cattle and beef, we adopt a modestly less bullish outlook for prices through year-end on two accounts. First, feedlot inventories at July 1, 2010 stood 3.3% above year-ago levels and suggest modestly larger beef output relative to our expectations during 4Q10. In addition, resilient ground beef prices (as depicted) may also drive larger dairy cow slaughter in 2H10 – the mix of dairy cows within U.S. monthly cattle slaughter has remained above the 5-year average since February 2010. However, we remain bullish on the 12-month cattle price outlook as 7/23/10's semi-annual USDA *Cattle* report indicated continued contraction in the U.S. herd. At July 1, 2010, the U.S. cattle and calf inventory was reported down 1.2% YOY, with beef cows down 1.6% YOY, and beef replacement heifers down 2.2% YOY, respectively. The inventory outlook continues to support the USDA's estimate for a 2.1% YOY beef output decline in 2011.

U.S. CATTLE FEEDLOT INVENTORIES



Note: Year/year change in U.S. cattle feedlot inventories; first of the month
Source: USDA

U.S. GROUND BEEF AND RIB-EYE STEAK PRICES



Source: USDA

For lean hogs, we adopt a modestly more bullish near-term price outlook given stronger than expected recent export demand (notably to Japan and Russia) and domestic price increases driven by elevated foodservice bacon promotions (pork belly prices recently reached an all-time record). Looking out through year-end, recent oppressive U.S. heat is likely to further stress seasonal hog weight gain (reducing slaughter weights) and the USDA's June 25, 2010 *Quarterly Hogs and Pigs* report indicated a much larger than expected 5.4% YOY decline in market hogs weighing 50-119lbs at June 1, 2010. As such, we also expect progressively lower head slaughter in 4Q10.

Looking ahead to 2011, we continue to expect industry productivity rates will expand at a rate near 2% and, barring a further escalation in feed prices, increased profitability may also yield modest YOY farrowing expansion. Such a scenario would augur potential upside risks to the USDA's existing forecast for 2011 YOY pork output growth of 2% off an expected 3.3% contraction in 2010. As it relates to our coverage universe, we expect guidance related to Sara Lee's 12-month protein cost outlook when it reports Fiscal 4Q10 earnings on August 12, 2010. In the interim, we reiterate our view that YOY hog price inflation will moderate into 2011 and that the January 2011 commissioning of Sara Lee's new low-cost Kansas City sliced meat facility augurs material efficiency and cost savings opportunities.

This month, we are lowering our 2010E average CME Live Cattle price forecast to \$93.05/cwt. from \$94.51/cwt. prior, but are raising our 2010E CME Lean Hog price forecast to \$77.63/cwt. from \$73.49/cwt. prior.

TAG 12-MONTH LIVESTOCK PRICE FORECASTS

Commodity	TAG Quarterly Price Forecasts										TAG Annual Price Forecasts		
	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10E	4Q10E	1Q11E	2Q11E	2009	2010E	2011E
CME Live Cattle (\$/cwt)	83.55	83.29	85.19	83.38	90.49	94.18	92.77	94.75	96.96	97.00	83.85	93.05	96.74
Year/Year	(8.6%)	(10.6%)	(15.7%)	(6.0%)	8.3%	13.1%	8.9%	13.6%	7.1%	3.0%	(10.4%)	11.0%	4.0%
CME Lean Hogs (\$/cwt)	60.12	61.45	53.22	57.79	69.75	82.28	82.38	76.13	75.20	78.63	58.15	77.63	74.54
Year/Year	3.9%	(15.5%)	(28.6%)	(2.2%)	16.0%	33.9%	54.8%	31.7%	7.8%	(4.4%)	(12.0%)	33.5%	(4.0%)

Source: CME, TAG research and estimates

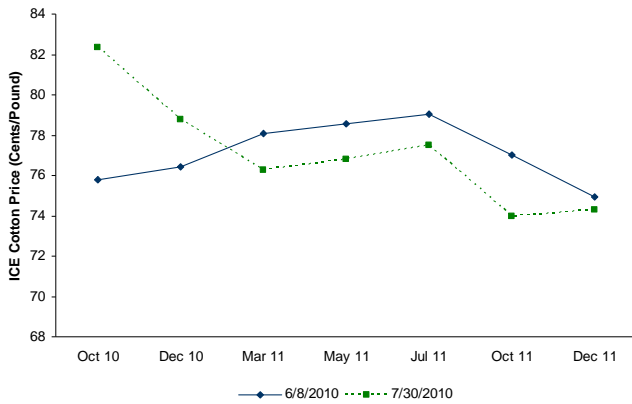
> SOFTS (COTTON, COFFEE, COCOA)

We lead off with updated commentary on our cotton outlook – the feature focus of our 6/8/10 June *Food Commodities Monthly*. As a reminder, we offered our view that the global cotton supply/demand environment would likely remain tight over the near term and as such, downside risks to cotton prices would largely be limited. Further, our expectations for flattish absolute ICE cotton prices (in a mid-70 cent/lb range) also implied the moderation of YOY inflation through 2H10 and followed by modest YOY deflation in 2011. Driving this view was our outlook for a strong YOY increase in global cotton production (up roughly 11.6% in the 2010/11 year beginning 8/1/10) combined with expectations for slightly moderating demand in the wake of supply chain re-stocking.

This month, we reiterate our expectations for a robust global cotton harvest (raised 230bp vs. last month to 13.9% YOY) given estimated U.S. production now 10% larger than our June forecast, limited crop damage in China after early season flooding, and a combination of larger acreage and a much improved monsoon season in India relative to 2009. Specifically in the U.S. (16% of global output), improved relative economics support an estimated harvested area now 6% above prior expectations (up 38% YOY) and ongoing favorable weather has improved YOY yield expectations by 4% (up 9% YOY) vs. our June estimates, respectively. Turning to our expectations for demand, we modestly raise our 2010/11E global demand to 3.5% from the prior 3.2% and despite projected larger 2010 output, our 2010/11E global stocks/use ratio is tightened to 41.5% from the prior 42% on lower-than-expected inventories to begin the year (2009/10E global stocks/use is revised to 43.9% from the prior 45% on better 1H10 demand).

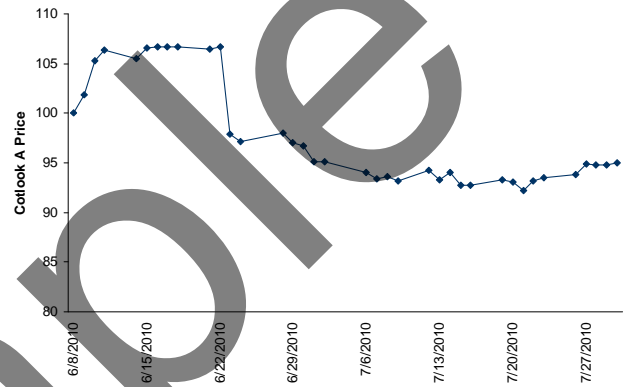
Translating the cotton market's fundamentals into price expectations, we note the divergence of performance since our 6/8/10 *Monthly* between ICE-traded cotton near futures and the Cotlook A Index. As a reminder, the *Cotlook A* is viewed as a broader proxy for international prices given its attempt to capture the price for a basket of cottons commonly traded across global markets. As depicted, longer-dated ICE-traded contracts and the *Cotlook* index have declined consistent with our views (*Cotlook* down 5% from 6/8/10 and 11% from the 6/22/10 high) and anecdotally, we have heard that yarn inventories may be building in China. By contrast, the October 2010 ICE contract has increased 8.6% as it reflects ongoing supply tightness ahead of harvest (existing U.S. cotton inventories are at the lowest levels in over 5 years), with deferred contracts weakening amidst expectations for a more robust harvest.

ICE COTTON FUTURES CURVE



Source: ICE

COTLOOK A INDEX PRICE HISTORY

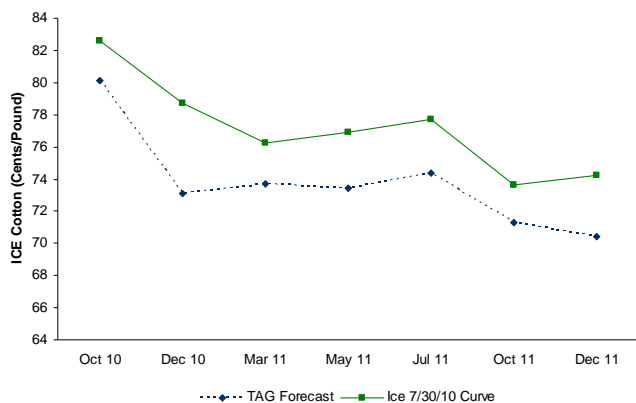


Note: Indexed to 100 at 6/8/10

Source: Cotlook

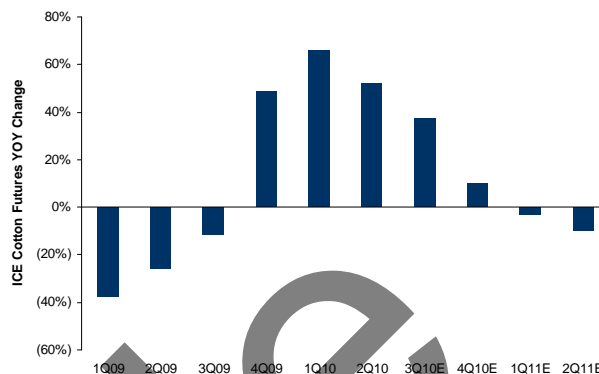
This month, we are raising our expectations for the 3Q10 ICE price to 81.3 cents/lb from 75.9 cents/lb prior and our 4Q10E price to 76.1 cents/lb from the prior 72.3 cents/lb to reflect ongoing near-term supply tightness. We maintain our 1Q11E of 73.5 cents/lb and continue to expect modest YOY deflation in 2011 (down 7% vs. 2010E's increase of 38%). In closing, we reiterate our view that cotton prices remain subject to a sudden spike should 2010's harvests disappoint and/or if global economic recovery materially surprises to the upside (though each scenario appears less likely). We cite the recent spike in coffee prices as an example of a theoretical price path should such a scenario unfold (coffee commentary follows).

ICE COTTON FUTURES: TAG FORECASTS VS. CURVE



Source: ICE, TAG research and estimates

ICE COTTON ESTIMATED YOY PRICE CHANGE

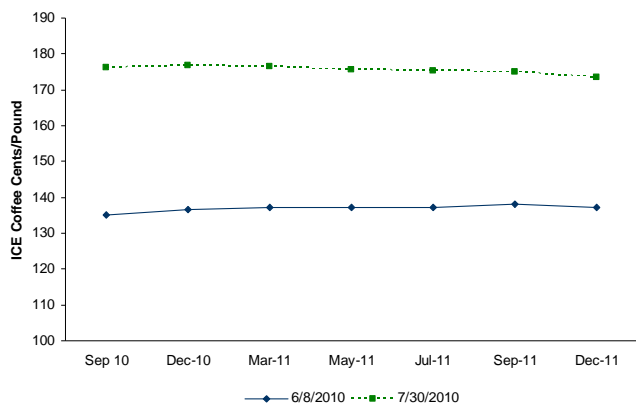


Source: ICE, TAG research and estimates

Turning to coffee, average ICE July near-futures rose 9% following June's 12% increase and closed up 27% YOY – prices spiked 32% alone between 6/7/10 and 7/30/10. The primary driver behind such strength is the combination of an increasingly disappointing outlook for the Central American harvest (particularly in Colombia and also on complications from Tropical Storm Agatha in late May), reports of lower-quality beans in Brazil, and reduced Robusta output in Vietnam. Broadly speaking, the recent run-up may appear justified in the sense that coffee prices had been trading within a somewhat depressed \$1.30s range prior to the recent advance and our 2010/11E global stocks/use of 26.9% would mark the tightest ratio for an “on-year” in Brazil this decade. As a reminder, Brazil experiences a biennial cycle of larger production followed by one of smaller production – the current harvest marks an “on-year” of larger output. Given the inability to more broadly expand global stocks/use ahead of next year’s “off-year” of lower production, it is only natural that the entire coffee futures curve has blown out in anticipation of extended supply tightness (as depicted).

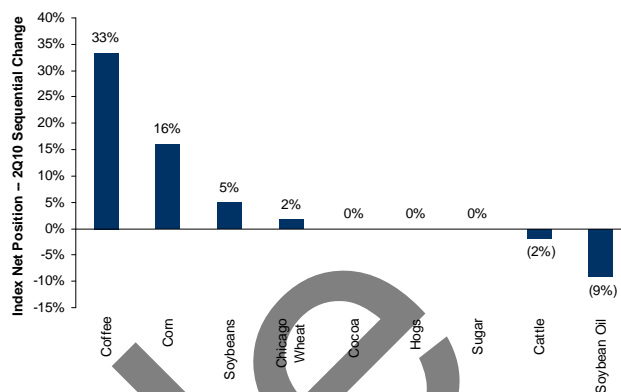
That said, we believe the recent rally may have been excessive and in addition, that realized cost inflation for producers such as Sara Lee and Kraft may ultimately prove less than what ICE futures suggest. First, as it relates to the rally, ICE futures have benefitted from a massive increase in money flow over the past quarter. As depicted, the reported net long notional position of index investors rose 33% between 1Q10 and 2Q10, and is also up 125% YOY – the largest increase across our tracked commodities. In contrast to last year’s unseasonal rainfall which is impacting the current Brazilian harvest, more normal precipitation this year is quietly raising the potential that Brazil’s off-year output decline in 2011 may not be as dramatic as in years past. As such, we believe ICE futures could be subject to some profit-taking as the supply situation stabilizes.

ICE COFFEE FUTURES CURVE



Source: ICE

AGRICULTURAL COMMODITIES INDEX NET POSITION



Source: CFTC

From a buyers' perspective, we clearly anticipate inflationary cost pressure within the coffee cost structures for Sara Lee and Kraft over the next 12 months, but the severity may be tempered on two fronts. First, we believe hedging and OTC sourcing may temper some of the inflationary impact. Second, we highlight the somewhat limited nature of the ICE's "C" contract structure – deliverable supply is largely limited to that from Central America (excluding Brazil). As such, while coffee prices are likely headed higher globally, the diversified sourcing base of multinational coffee procurement may drive YOY inflation at a rate below that which the ICE contract might otherwise suggest. Also worth consideration, inflationary coffee costs could prove somewhat beneficial as they will likely constrain the ability of private label to aggressively discount across Europe – a source of Sara Lee's recent roast & ground volume challenges in isolated markets. We are raising our 2010E ICE coffee price forecast to \$1.47/lb. from the prior \$1.32/lb. and look for greater commentary on the sourcing outlook during Kraft's 2Q10 EPS call on 8/5/10 and on Sara Lee's Fiscal 4Q10 EPS call on 8/12/10.

Shifting to the cocoa market, average July ICE near futures closed up 0.6% sequentially and stand 10.4% higher YOY. In recent weeks, investors have followed media reports suggesting that a speculator had accumulated cocoa supplies in an effort to drive prices higher. We firmly believe that this will not have any adverse impact on sourcing for Hershey or Kraft/Cadbury for two reasons. First, the companies maintain well-established sourcing contracts and are not dependent on the spot market. Second, any speculative inventory accumulation was likely designed to exploit the seasonal lull in production prior to Western Africa's primary harvests beginning in October. As fresh supply reaches the market, it will outweigh any non-commercial inventory build.

Turning to market fundamentals, recently reported 2Q10 EU and N. American cocoa grindings rose 13% and 12% YOY, but lapped weak 2009 comps (-11% and -7%, respectively). Still, North America exceeded our estimate (up 10%) and the EU's 3.6% sequential 2Q grind decline was the smallest seasonal drop since 2006. Better demand, combined with potentially lower supply, maintains a floor for prices into 2011. We are raising our 2010E cocoa price forecast to \$3,022/MT (up 8.1% YOY) from our prior \$2,975/MT. We also acknowledge the potential that black pod disease may weigh on the Ivory Coast's harvest over the next few months (roughly 40% of global production). Speculation over cocoa crop sickness is a frequent occurrence, but the industry's tightening supply/demand fundamentals suggest little margin for a production shortfall – should the upcoming harvest disappoint, upside risks exist to our 2010 and 2011 cocoa price forecasts. As it relates to Hershey, we reiterate our thesis that the company will likely begin to encounter secularly rising cocoa costs towards the end of 2011, which we expect will weigh on opportunities for margin upside in the out years of our model.

TAG 12-MONTH SOFTS PRICE FORECASTS

Commodity	TAG Quarterly Price Forecasts										TAG Annual Price Forecasts		
	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10E	4Q10E	1Q11E	2Q11E	2009	2010E	2011E
ICE Coffee (\$/lb)	1.13	1.24	1.25	1.39	1.34	1.39	1.59	1.55	1.55	1.55	1.25	1.47	1.56
Year/Year	(20.7%)	(8.8%)	(9.5%)	24.2%	18.5%	12.8%	27.6%	11.8%	15.6%	11.4%	(5.2%)	17.5%	5.8%
ICE Cocoa (\$/mt)	2,558	2,495	2,868	3,257	3,080	2,987	3,003	3,020	3,075	3,092	2,795	3,022	3,144
Year/Year	5.5%	(10.0%)	3.1%	45.0%	20.4%	19.7%	4.7%	(7.3%)	(0.2%)	3.5%	9.4%	8.1%	4.0%
ICE Sugar (cents/lb)	12.73	14.71	20.55	23.64	24.39	15.51	17.41	16.86	16.46	15.59	17.91	18.54	15.38
Year/Year	1.5%	31.2%	57.4%	103.6%	91.6%	5.4%	(15.3%)	(28.7%)	(32.5%)	0.5%	47.9%	3.6%	(17.1%)
ICE Cotton (cents/lb)	45.77	53.60	59.20	69.18	75.88	81.33	81.33	76.10	73.50	73.40	56.94	78.66	72.99
Year/Year	(37.5%)	(25.8%)	(11.5%)	48.9%	65.8%	51.8%	37.4%	10.0%	(3.1%)	(9.8%)	(12.0%)	38.2%	(7.2%)

Source: CME, TAG research and estimates

Sample

ADDENDUM

Important Disclosures:

Valuation Method for Target Price: Price-to-Earnings, price-to-EBITDA, P/E to growth, price to free cash flow, and discounted cash flow analysis.

Investment Risks: Slower consumer spending, rising interest rates, weaker consumer confidence, rising unemployment, supply chain disruptions, fashion misses, and excessive markdowns.

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John J. Baumgartner, CFA

Historical Price Targets

To see price charts and TAG's historical price targets please click the following link: <http://www.telseygroup.com/files/historicalprices.pdf>

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