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FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 19, No. 5 June 30, 2016

Cotton: the Chinese stock bubble is deflating

Cotton prices continue to wander aimlessly in a relatively tight range. Most recently, the market is trading near the top of the range (Chart 1).

The operative fundamental most discussed is the burdensome stockpile in Chinese warehouses. The May USDA crop report estimates that 2015-16 ending stocks will be equal to 200% of domestic mill consumption. With government policy aimed at reducing these stocks, Chinese imports should remain weak.

The May USDA report did not contain any shocking revisions for 2015-16, but the outlook for the upcoming 2016-17 marketing year – which begins on August 1 – is somewhat more friendly for prices.

The estimate for 2015-16 US exports was lowered by 500,000 bales, to 9 million bales. Even if the new target is met – possible, but doubtful – it would be the smallest export tally for the US since 2000-01. Export commitments stand at 8 million bales, but only 6 million bales have been shipped. Weekly shipments would need to average about 300,000 bales, which is below the recent average. It would be highly unusual to see significant shipment increases for this time of year.

As a result of lower US exports and some upward revisions to output, the estimate for 2015-16 global ending stocks was raised to 94.32% of consumption, up from the April estimate of 93.27%. All told, a seemingly hopeless bearish situation.

Turning to 2016-17, US cotton area, based on planting intentions, is expected to expand by 1 million acres, or 11.4%. At 766 pounds per acre, last year's yields were poor. The USDA is forecasting a recovery to 807 pounds per acre. Output is estimated at 14.8 million bales, up from 12.89 million bales harvested in 2015-16.

The planting season has not been ideal. Weekly USDA progress reports show that 46% of the crop has been planted, ahead of last year's 44%, but well behind the five-year average of 56%. So the estimate for the recovery in output will come under scrutiny until the crop is in the ground. Then there is growing-season weather to worry about.

Chinese production peaked in 2012-13 at 35 million bales. The anticipation of the implementation of the government policies, intended to make a meaningful dent in inventories, has driven domestic prices down, dampening the incentive to plant cotton. As a result, planted area has plummeted. After harvesting only 23.8 million bales in 2015-16, the USDA puts 2016-17 Chinese production at a multi-year low of only 22.5 million bales. And that, of course, assumes favorable weather conditions.

While the announcement of the Chinese stock reduction program only made headlines recently, the program has been in place for some time. The initial estimate for 2016-17 Chinese ending stocks contained in the May crop report showed a drop of 6.6 million bales, or 10% below 2015-16. After incorporating the stock reduction into the global balance sheet, stocks as a percentage of consumption for the new marketing year are estimated to fall to 87.1%, down from 94.32% in 2015-16.

Crops in India and Pakistan are expected to see an improvement from last season's weak crops. The performance of the June through September monsoon, however, is crucial to those crops.

Broadly speaking, we think the market has bottomed. We've been trading at the same price for two years. That

Inside

Copper: Beyond the headlines	2
Corn: Lives yet the bull?	4
Sugar: A great idea, or what?	5

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qualifies as a base. With the supply/demand fundamentals clearly not as bearish as they've been, as we've made some progress in whittling down stocks, we do not see much risk in this market setting new lows.

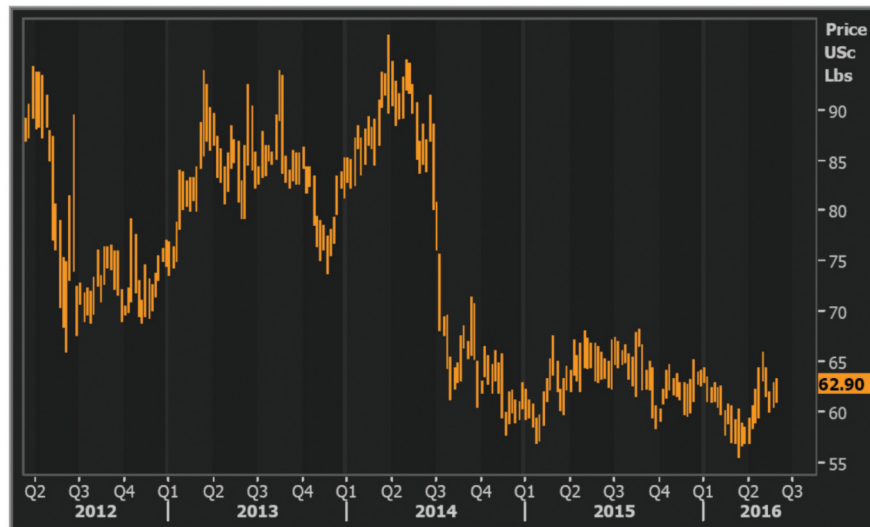
We believe that the US crop becomes a vulnerable factor now, because after all, the US is still the exporter of last resort. While Chinese import needs have fallen substantially,

they still rely on foreign cotton for higher-quality supplies. In addition, there are other Asian nations that rely on the US for imports. As El Niño shifts to La Niña, drought conditions are a strong possibility in the US.

Buy December cotton, now trading around 62.5¢ per pound. Place initial stops at 60¢, close only.

[Sholom Sanik, May 26, 2016]

Chart 1 – Cotton weekly nearest contract



Courtesy Reuters

COPPER

Reading beyond the headlines

Between June 3 and June 8, LME copper warehouse stocks spiked 60,000 tonnes, or 40% (Chart 2). In conjunction with the rise, the cash-to-3-month spread plunged from backwardation into contango (Chart 3). Before the sudden increase in inventories, copper prices were consolidating, but the market sold off to three-month lows after the inventory increase (Chart 4).

In terms of global/supply demand fundamentals, however, the headline-grabbing movement of LME stocks is a bit deceptive. From mid-March through the present, Shanghai warehouse stocks have tumbled precipitously, by more than 200,000 tonnes, a drop of 54%. Combined global warehouse stocks – which also include COMEX – have actually fallen to one-year lows (Chart 5). So to the extent that warehouse stock levels are a useful indicator at all, the recent overall activity would actually be bullish for prices!

In any case, the two primary supply/demand fundamental gauges remain bullish.

Chilean output for 2016 is forecast to be little changed from 2015. Even meeting 2015 output levels will be a chal-

lenge when considering the pace of monthly production. Average monthly production is down 4.7% year-over-year.

Part of the problem has been heavy rains resulting from the tail end of El Niño, which caused some serious production halts at some mines. With favorable weather conditions, we should see output stabilize. However, even as temporary hindrances such as weather and labor strife fade, declining ore grades should mean that any production recovery will be muted.

Counterintuitive as it may seem, Chinese *apparent* demand, otherwise known as imports, is as strong as ever. While economists bemoan the sorry state of Chinese growth and the allegedly faltering loan business that uses copper as collateral, imports continue to soar. March imports rose to a record monthly high. April and May were a bit lower, but still higher year-over-year. We keep reading that if the high volumes of imports are not headed for industrial usage and merely end up in warehouses, it is only a matter of time before we see a sharp drop in imports. And while it is quite a logical argument,

it has not materialized yet.

According to the International Copper Study Group's most recent report, the global balance sheet is showing a small surplus so far this year. If current trends in Chilean production and Chinese imports were to continue, we do not see how this surplus could grow. Rather, we envision a slide towards a balanced market at best, and possibly into deficit.

COMEX open interest sits at record highs. Commodity funds swung from a sizeable net-long position in early March to a current net-short position of 37,000 contracts (Chart 6). We believe the bearish exuberance is unwarranted because – as illustrated above – the fundamentals do not support it.

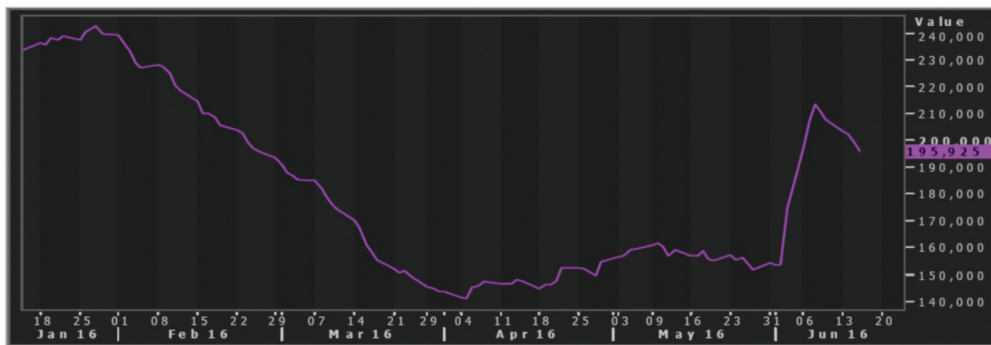
Additionally, we have shifted into an environment of a broad rise in commodity prices. Specifically, with petroleum and natural gas prices trading sharply off their lows, the rising cost of energy could manifest itself in higher production costs for miners, which will ultimately be passed on to the consumer.

In conclusion, with prices trading at seven-year lows, miners are not motivated to crank up output. Prices will have to move higher to bring new supply to market. We see a short-covering rally around the corner.

Buy September copper. Place initial sell stops at \$1.99 per pound, close only.

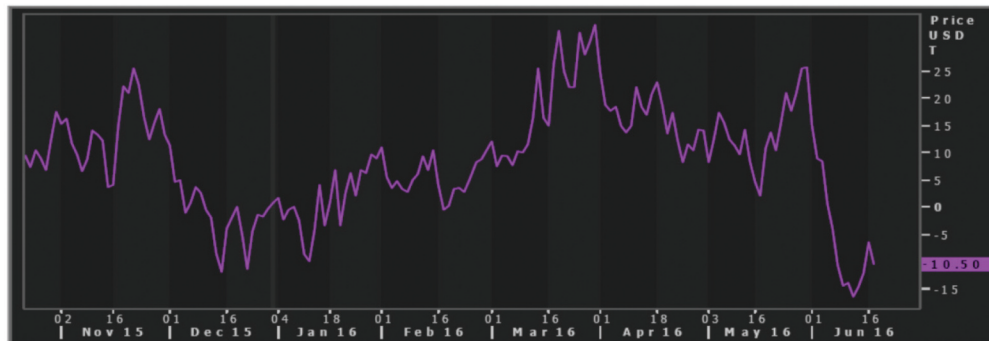
[By Sholom Sanik, June 17, 2016]

Chart 2 – LME copper warehouse stocks



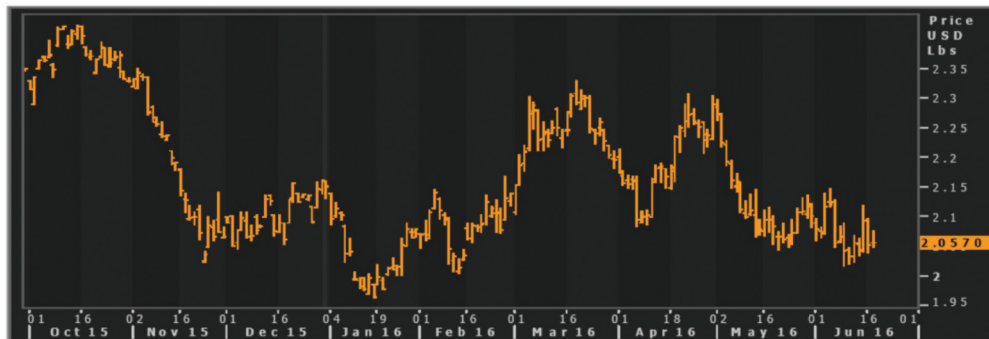
Courtesy Reuters

Chart 3 – LME copper cash-3 month spread



Courtesy Reuters

Chart 4 – September copper



Courtesy Reuters

Chart 5 – Combined LME, Shanghai, and COMEX

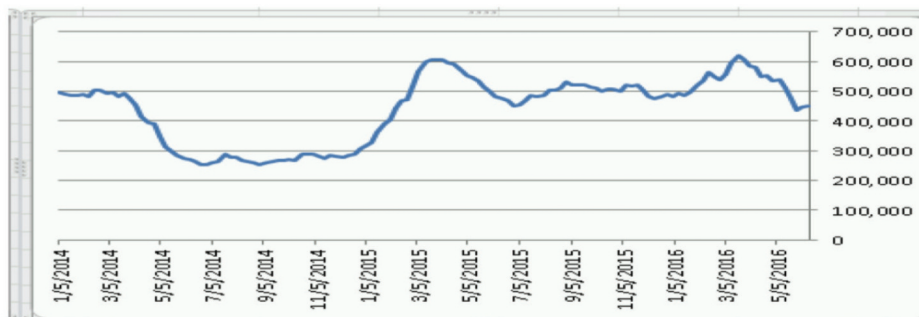
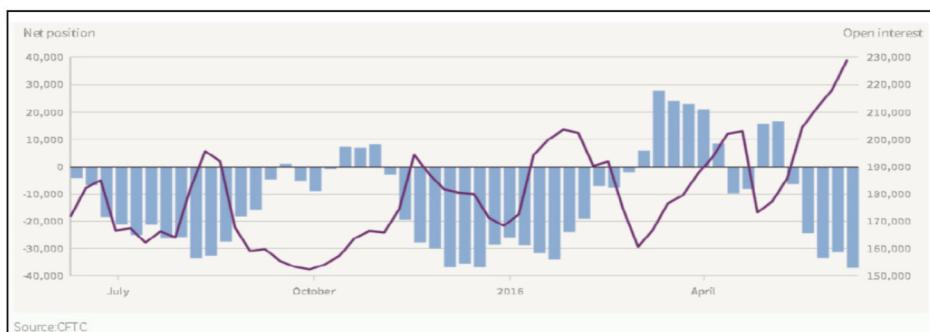


Chart 6 – Commodity net short position and open interest



CORN

Is the bull still alive?

Before the spring rally began in the corn market, the bear market seemed intact. Forecasts for US planted area of 93.6 million acres would be the largest since 2013-14. A picture-perfect planting season promised near-record yields of 168 bushels per acre. South American producers were set to harvest near-record crops.

The first glitch in the amply-supplied-market scenario to present itself was inclement harvest weather in Brazil. Before the harvest season began, the estimate for 2015-16 output reached 84 million tonnes, just shy of the record set in 2014-15. Analysts really did not have a serious grasp on just how much of the crop was lost. The average guesstimate heading into the June 10 monthly crop report was 79 million tonnes. The June USDA crop report slashed that estimate to 77.5 million tonnes. On June 22 the USDA attaché lowered that estimate further, to 75 million tonnes.

Once the US corn crop was planted, hot and dry weather evoked memories of past droughts, and traders drove prices of new-crop December corn close to \$4.50 per bushel (Chart 7). From late-March through the present, commodity funds piled onto the long side *en masse*. The net-short position of 265,000 contracts turned into a net-long position of 272,000 contracts.

Bona fide tightness developed as a result of the smaller Brazilian crop. There's been a ripple effect. The govern-

ment has relaxed import taxes to facilitate purchases of corn and other key staples. Brazilian ranchers have been forced to import corn from Argentina. Normally, at this time of year, overseas importers shift away from the US to South American origins. But because of Brazil's supply problems, the US export business continues to bustle. Over the past six weeks, US export commitments averaged 1.24 million tonnes, compared with only 590,000 tonnes in the same period last year.

Earlier this marketing year, US exports were expected to lag 2014-15 by a wide margin. Commitments now stand at 45.5 million tonnes, compared with 44.5 million tonnes at this time last year. In response, the June USDA estimate for annual sales was revised upwards again, to 46.36 million tonnes. As recently as April, the estimate stood at 41.91 million tonnes.

Most recently, forecasts for some wetter weather sparked a correction that saw heavy liquidation. The market shed 50¢ per bushel in just a few sessions, dragging December corn back below \$4 per bushel. Was that the end of the rally?

It does not seem that the funds have finished their selling. The June 22 release of the USDA attaché report that showed Brazilian output at only 75 million tonnes should have breathed some life into the market. But the selling

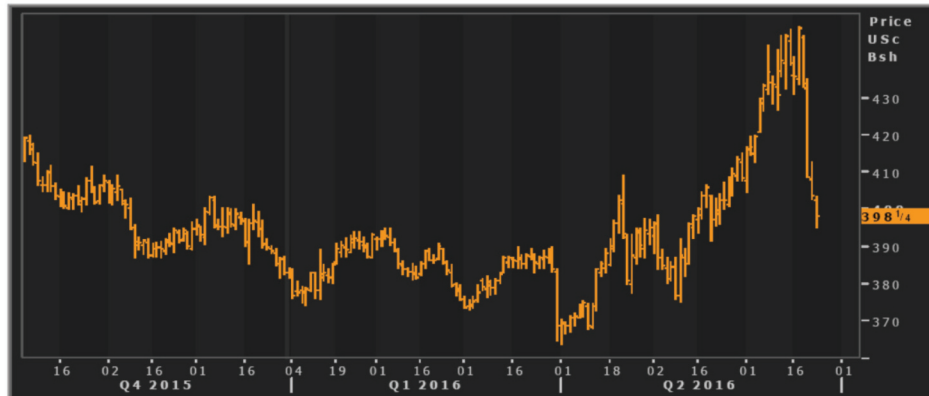
continued, dragging December corn below \$4 per bushel. Open interest fell by 55,000 contracts, or 3.5%, during the few days of heavy selling (Chart 8). But that made only a small dent in the massive long position accumulated during the rally. So there may be more pain for the bulls, at least in the short term.

Nevertheless, we do not believe that the market is headed back to the lows. The disappointing Brazilian crop and the unusual demand for US corn this late in the marketing year

have changed the dynamics of the market. Furthermore, with the possibility of a hot summer, it is far too early to assume that the USDA estimate for near-record yields of 168 bushels per acre for the 2016-17 crop to be harvested this fall is in the bag. We view the sharp selloff in terms of a due-course correction in a budding bull market.

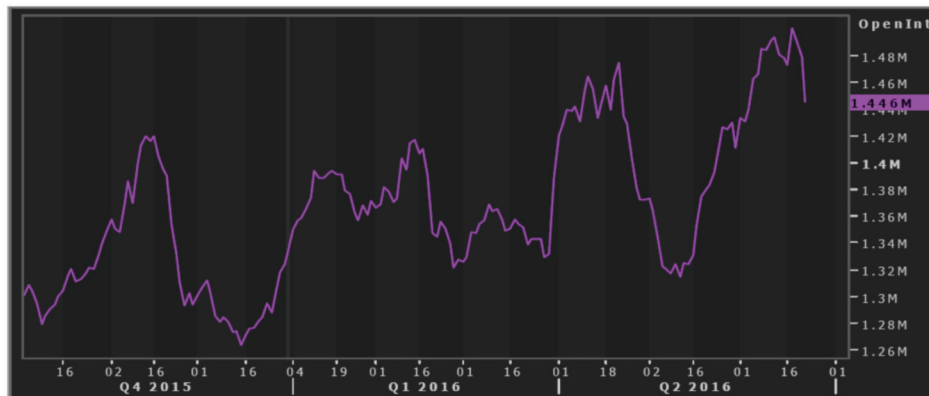
Hold on to long positions in December corn and maintain sell stops at \$3.60 per bushel, as per our May 22 recommendation. *[By Sholom Sanik, June 24, 2016]*

Chart 7 – December corn



Courtesy Reuters

Chart 8 – Corn open interest



Courtesy Reuters

SUGAR

Indian sugar exports: Was that a great idea?

The surprise outcome of the Brexit referendum triggered a selloff in commodities. Many markets – particularly grains and softs – rose through mid-June but had become overburdened with massive long fund positions, and there was a correction in progress even before the historic vote took place. The Brexit result just dealt a further pounding, and sugar was no exception. What separated sugar from the pack was that within a couple of days, sugar prices set new

highs dating back to October 2012.

Several developments over the past few weeks have underscored the bullish fundamentals that we've been discussing.

In early May, estimates for 2016-17 Brazilian output were running three to four million tonnes above the previous crush season. Then heavy rains brought the crushing season to a halt. Enough crushing days were lost in the last

half of May and the first half of June to raise concerns that forecasts for a bumper crop might have been premature.

This uncertainty over the size of the Brazilian harvest surfaced while the market was grappling with the fallout from crop losses in India, the world's second-largest producer behind Brazil, which underscored the looming deficits in the global sugar market.

Recently, while the Indian government was busy assuring the market that the country's sugar supplies were sufficient to meet domestic consumption, it simultaneously imposed export restrictions. A 20% tax was slapped on exports. It is somewhat amusing to observe that earlier in the 2015-16 marketing year, the government instituted measures to create incentives for Indian exporters to sell abroad. So far this marketing year, exports have totaled 1.7 million tonnes, but that will be the last Indian exports we see for some time. In the February 24 issue of *Focus on Futures*, we predicted correctly that not only was the export incentive ill advised, but that we may reach a point at which exports will be restricted.

Drought in key growing regions left estimates for 2015-16 Indian output at 25.2 million tonnes, down about 4 million from early season estimates.

Looking ahead to 2016-17, any hope for a decent-sized crop will depend heavily on the strength of the June through September monsoon. The rains came late, prompting analysts to forecast production at only 23.5 million tonnes. The sharp

drop in sugar prices earlier this month was due in part to the late start of the monsoon. The rains have now arrived, but it is too soon to know if the parched areas will receive enough precipitation to facilitate a crop recovery.

To illustrate, consider the situation in Maharashtra State, a key growing region. A recent estimate puts sugar output for the new crop year at 4.5 million tonnes, down from 8.4 million tonnes and 10.5 million tonnes in 2015-16 and 2014-15, respectively.

In a sense, the bull run has done its job. With world prices now trading at over 20¢ per pound, the sprice has finally reached the cost of production in Brazil and India. Prices spent most of the past several years below 15¢ per pound while costs were closer to 20¢ per pound. Money-losing mills ceased operations. In India, over the past five years, more than 20% of all mills halted operations.

The bull market, however, is far from over. The problem is twofold. The money-losing idled plants are not just going to pop up and resume crushing. There are no plans in the works to bring increased capacity back on line. Furthermore, expanding capacity is not going to help much if there is not enough cane to crush – courtesy of the weather.

Analysts are unanimous in their forecast for the 2016-17 global balance sheet, calling for a deficit of between 4 million tonnes and 7 million tonnes.

Hold on tightly to your long call option positions.

[By Sholom Sanik, June 29, 2016]

Chart 9 – Weekly ICE sugar



Courtesy Reuters

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