FRIEDBERG'S
FOCUS ON FUTURES

Friedberg Commodity Management Inc.

Volume 4, No. 5 June 4, 2001

The clash of a massive 'discovery' of Chinese wheat stocks and a shrinking US wheat crop

It was well known that the USDA intended to revise Chinese ending stocks of grains in its May supply/demand situation report. The USDA attaché for China gave us a hint that this was coming back in February. The amount of the revision, however, did come as a shock, particularly for wheat.

As recently as the morning of the report's release, we still saw estimates of Chinese 2000-01 ending stocks jumping to 25 million tonnes from 13 million tonnes in the April 10 report. When the May 10 report first flashed across our screens indicating that the USDA had raised Chinese ending stocks to 54 million tonnes, we were certain it was a typo. But it was not.

Taken at face value, this revision alters the global wheat picture dramatically. Global stocks will grow to 158 million tonnes from the 108.94 million tonnes estimated in last month's report. This will raise stocks as a percentage of consumption to 27% from last month's 18.5%. How can there have been such a mistake? Does this effectively mean that the bear market is still alive and well? Will prices sink to yet another round of new lows?

It is rather demoralizing to think that we've been living and trading with such misguided assumptions about the Chinese wheat situation. While we certainly do not question the USDA's integrity, its explanation of the information void – offered in notes accompanying the report – was rather lame: "China's government does not publish estimates of grain stocks. In the past, USDA's independent estimates of stocks performed well as an indicator of China and world grain market conditions. Recently, however, new information from China's first agricultural census, official statements, and evidence from trade and price patterns indicated that revisions in stock estimates were needed to reflect more accurately grain supply and use in China." Whatever.

Assuming that this version of the Chinese situation is a more accurate reflection of reality, we can now better understand why wheat prices have been so weak for so long. Ending stocks *appeared* to be contracting to dangerously low levels. In fact, production has been falling for years, and inventories were contracting, but not to dangerously low levels. The large Chinese purchases we anticipated never materialized, because the country had an ample supply.

Overall, though, the USDA report was construed as bullish by traders. Global output for the new crop year is expected to fall yet again to 572 million tonnes from 580 million tonnes in 2000-01, marking the fourth consecutive year of smaller crops. On the new ending-stocks-standard, stocks will fall from 158 million tonnes (27% of consumption) at the end of the 2000-01 marketing year to 139 million tonnes (23.6% of consumption) by the end of 2001-02.

The most bullish contribution comes from the US. American farmers planted the smallest winter wheat

In this issue

2 **Platinum**
Platinum bull clings to life

3 **Petroleum**
The bull market in petroleum is aging

4 **Soft Commodities**
Soft Softs

6 **Hotline Update**

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

Focus on Futures available by e-mail

Focus on Futures is available by e-mail as a Portable Document Format (PDF) file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please let us know. Send us a message at focus@friedberg.com and give us your e-mail address as well as your full name and street address.

acreage in decades. The world's largest exporter of wheat will yield a crop of only 53.38 million tonnes, down almost 12% from last year. Analysts' average estimate of 55.72 was way off the mark. Despite a forecast for a 5.7% drop in useage in both exports and domestic demand, the crop will be small enough to cause US ending stocks to drop to 16 million tonnes, or 26% of consumption, compared with last year's 22.5 million tonnes, which represented a much higher 34% of consumption.

US weekly export sales continue at the sluggish pace of about 250,000 tonnes per week, well below the average weekly total that would be required to meet the USDA's forecast for 2000-01 exports of 30 million tonnes. The USDA maintained its forecast in the May report because both commitments and shipments continue to run slightly ahead of last year's export statistics at this juncture of the season, indicating that we could still be in a position to reach the target.

The discovery of the hidden Chinese inventories has not caused any further damage to prices. In fact, the market has been up since the release of the report. We continue to believe that wheat is very cheap at these levels when viewed from a historical perspective. The USDA/China wheat fiasco may turn out to be the mother of all buy-the-rumor-sell-the-news (or in this case, sell-the-rumor-buy-the-news) classics. Keep posted. *[May 14, 2001]*

CURRENT STRATEGY: *We are long July wheat as per Flash Update of May 21. Raise stops to 261, close only.*

PLATINUM

Platinum bull clings to life

Platinum group metals (PGM) have enjoyed a spectacular bull market since setting their lows in the fall of 1998. Platinum prices have almost doubled. Palladium more than tripled in price during this period. Despite having shed about half those gains since the start of this year, palladium is still double the price it was only six months ago. Are these prices sustainable? (We focus primarily on platinum. Although both are very thin markets, platinum is tradeable, but palladium is so illiquid that it's not advisable to mess with it at all.)

A growth spurt in consumption and restricted Russian supplies combined to propel prices to the stratosphere. Both those factors, however, have mellowed.

In its recently released report, Johnson Matthey (JM) estimates that Russian platinum supplies more than doubled in 2000, to 1.1 million ounces from 540,000 ounces in 1999. This puts Russian supplies back to the levels of the period before the bureaucratic logjam. Average supply for the 5 years prior to 1999 was 1.14 million ounces. While there is no guarantee that the Russians won't play this game again in a bid to drive prices higher, for now, supplies are forthcoming.

Although Russian palladium supplies fell by 3.7% in 2000, they never fell as much as supplies of Russian platinum. Palladium supplies were down only 6.8% in 1999 compared with a 58% drop in platinum supplies that year.

Overall, platinum supplies increased by 420,000 ounces in 2000. With an additional 560,000 ounces of Russian supplies on the market, newly mined platinum supplies actually fell last year.

After growing steadily throughout the 1990s, South African production fell by 100,000 ounces because of weather and labor problems. Without these drawbacks, JM forecasts that South African production will increase substantially this year.

High prices have inspired investment. South African mining companies have expanded production aggressively. By the middle of the decade, output by Anglo Platinum alone is expected to increase by 1.5 million ounces per annum. With the supply problems on the Russian and South African fronts seemingly clear we can no longer look to the supply side for a bullish case. The question then becomes, how much of the strength in price was attributable to increased consumption?

Autocatalyst demand grew for both platinum and palladium in 2000. Platinum demand grew by 230,000 ounces, or 14%. Purchases of palladium by car manufacturers fell 230,000 ounces, or 4%. This is deceptive, because users went on a stockpiling binge in 1999, purchasing 5.9 million ounces that year and were well stocked. Actual palladium-based autocatalyst installations jumped 24% in 2000. Despite the increase in autocatalyst usage, total global demand for platinum was rather flat, growing only 1.8% in 2000.

Although stricter emissions legislation around the globe will ensure that autocatalyst demand remains strong, we believe that prices are very rich and at these levels, perhaps unsustainable. A good chunk of market share has gone to palladium, where autocatalyst demand has more than tripled since 1995. The designers of palladium-based autocatalyst technology probably did not envision that prices would go through the roof the way they have. Still, the palladium alternative is here to stay. But the growth rates that the two markets have enjoyed over the past five years cannot possibly continue.

Cash production costs for much of the platinum mined around the world are below $300 per ounce. This leaves a wide gap between market prices and costs, which will allow

producers to lock in profits. As prices stagnate – platinum prices have not made any significant headway in over six months – producers could start hedging programs that will put pressure on the market.

Nevertheless, there is no compelling reason to be short this market at this time. On the other hand, we believe that this bull market is mature. The series of crises that have made PGMs leap to dizzying heights – as illustrated – are well under control.

Our first foray into the short side of platinum back in April did not work. The market seems to be maintaining some poise. We will, however, be looking for signs of weakness to try our hand again. *[May 17, 2001]*

STRATEGY: *Remain sidelined, but stay in touch.*

Chart 1 – July Platinum

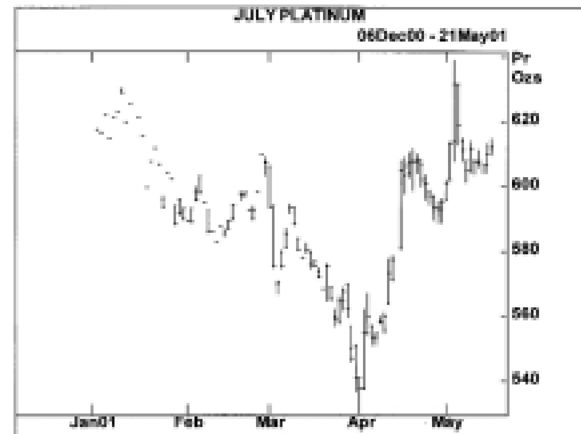


Chart courtesy of *Reuters*

PETROLEUM

The bull market in petroleum is aging

The slower rate of economic growth over the past few quarters has sent the price of many industrial commodities into a tailspin. Only a year ago it seemed that the expansion would continue unchecked into the foreseeable future. As consumption began to taper off, though, overproduction of commodities such as cotton, copper, zinc, and tin could not be absorbed and prices tumbled.

Although, crude oil prices have fallen substantially – spot West Texas is a full $10 per barrel below its September 2000 peak – at $27 per barrel, crude oil remains an expensive commodity. We make this assertion in terms of both the historical norm (crude oil traded below $20 per barrel for most of the 1990s) and the premium that producers are scooping (the cost of production for most of the crude produced in the world is still below $10 per barrel). For the latter, the case can be made that as demand continues to fall, there is ample room in the profit-margin column for producers to ram output up to compensate for lost revenues. Indeed, OPEC's overproduction caused the dramatic drop to $10 per barrel in late 1998, when it failed to anticipate the magnitude of the drop in consumption that hit the market during the Asian crisis.

There is a strong perception that the summer driving season will put a further strain on refineries that are already running near capacity. According to the Energy Information Administration's (EIA) latest statistics, refineries were running at 98% of their capacity for the week ended May 25, near the high end of the 90.3%-98.8% range of the past few months.

These output statistics tell one story, but other, more consumption-oriented indicators tell another. First and foremost are inventories. Stocks of unleaded gas, the culprit alleged to be keeping the bull in the petroleum complex alive, have risen significantly. This week's American Petroleum Institute's (API) weekly figures show that gas stocks rose 1.6 million barrels, slightly more than was expected. More importantly, gas inventories have now grown for 7 weeks in a row, which puts total gas stocks at 206 million barrels, close to 6 million barrels higher than at this juncture last year (Chart 2). This is in stark contrast to many gloomy media predictions of summer gas lines reminiscent of the oil shock of 1973.

A survey carried out by the American Automobile Association before the Memorial Day holiday week indicated that Americans would be hopping in their cars and SUVs at record levels and would not be scared off by the highest prices they've seen at the pump in years. The action at the New York Mercantile Exchange this past week, however, indicates that motorists were more cautious than they let on to the pollsters. July unleaded gas plunged from a high $1.02 per gallon to as low as 90¢ per gallon before stabilizing at 93¢ per gallon.

Despite a sharp, 4-million-barrel drawdown this week, crude stocks on the whole have been replenished. Stocks are now 19 million barrels above last year's levels and back to mid-1999 levels (Chart 3).

To present a balanced picture, however, we have to look at the other component in the complex. To meet the anticipated increase in demand during the summer driving season, refiners have been cracking their barrels in favor of unleaded gas at the expense of heating oil production. Every year, as the winter months wane, stocks of distillate fuels begin to build and do so until the next winter begins (Chart 4). That has not happened this year. In fact stocks of distillate fuels have dropped close to 20 million barrels since the start of the year. This week's data, though, show that the freefall may have been halted. The market was expecting an increase of 500,000 barrels, but stocks actually rose 1.9 million barrels.

For that matter, distillate stocks are still 3 million barrels higher than they were at the same time last year.

OPEC is not expected to raise production at its meeting next week in Vienna. It is warding off pressure from the White House and others to ease up on the production cuts it implemented over the past year. Industry analysts say that OPEC does not want to risk a sudden and steep slide in prices that would surely follow any announcement of an output increase, but would rather look aside and allow compliance to be compromised, which would effectively amount to a de-facto output increase.

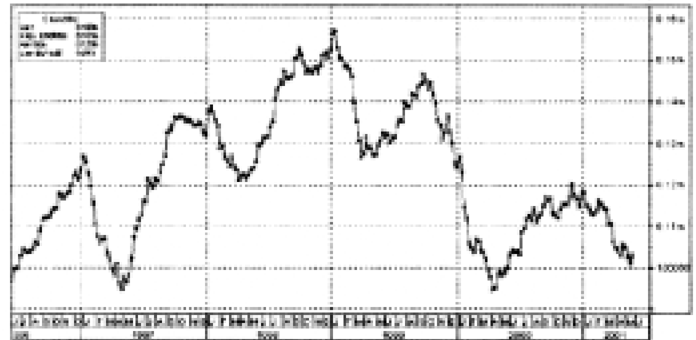
Only a few months ago, headlines warned of natural gas shortages. Few – ourselves included – would have believed that softer demand and the industry's rapid response to the supply/demand imbalances could have combined to replenish inventories and cause a stunning 35% drop in prices in the space of just 4 weeks. Once it becomes clear that there is no *bona fide* shortage of gasoline, we believe a similar scenario will unfold in the petroleum markets. *[June 1, 2001]*

CURRENT STRATEGY: *Remain short August crude oil as per Flash update of May 31. Lower stops to 29.25, close only.*

Chart 2 – API Unleaded Stocks

Chart 3 – API Crude Stocks

Chart 4 – API Distillate Stocks



Charts courtesy *Bloomberg*

SOFT COMMODITIES

Soft Softs

Cocoa

Only one week ago the cocoa bull seemed to be back in town. Having consolidated its near 100% increase in prices of earlier this year, it began a steady uptrend in mid-April and looked poised to breeze right past the $1,100 per tonne high set in March. No such luck. In the past four sessions, July cocoa plunged $125 per tonne, violating the lower end of the consolidation range and altering what was an otherwise positive outlook for prices to shades of the bear market we had become so accustomed to.

For many years, burdensome inventories made backwardation in the cocoa market nonexistent. Chart 5 shows a weekly continuation chart of the spread between the spot and the 1-year forward going back to mid-1995. Aside from a few incidents when the contango disappeared briefly because of expiry

related issues (see *Focus on Futures,* December 27, 2000), there has never been a sustained backwardation in this market, even during bull runs like the $400 per tonne rally in 1997.

On the surface, it seemed that the current market was unique in that its gains were complemented by tightening spreads. However the market began to invert in March only after the London Commodity Exchange (LCE) announced that it would not clear a backlog of cocoa submitted for grading. Rumors began to circulate about two weeks ago that the LCE was going to reverse that decision, which killed both the rally and the spreads.

The LCE confirmed yesterday that it was indeed going to allow the regrading of the beans in question. The market enjoyed a respite from worrying about large carryover stocks, because of the widespread belief that many of the beans could never be delivered. Traders will now have to resume worrying about those stockpiles.

That explains the recent string of events. It does not explain why the market began to tighten near the end of last summer. Cocoa prices rallied from their ugly, bear market lows because the Ivory Coast produced its smallest crop in years, while world demand continued to grow. Those factors have not gone away.

The political instability that played havoc with the migrant work force in the Ivory Coast and the collapse of its marketing board are issues that are not likely to disappear overnight. First quarter grindings showed a continuation of steady growth rates in demand.

The most recent Commitment of Traders report shows that both small and large speculators have moved onto the long side of the market. Open interest has grown by some 12,000 contracts since mid-April, and the recent drop in prices has not scared any of the speculators away. Well, it's pushed us out – for now – but we retain a longer-term bias to the bull side. It will be interesting to see how the spreads behave with the more lenient grading rules at the LCE.

STRATEGY: *We liquidated our long July cocoa positions as per Flash Update of May 30. Stay tuned.*

Sugar

The most important news to emerge in the sugar market in some time was the Indian government's decision to ease the bureaucratic roadblocks to sugar exports. India has sugar stockpiles reported to be more than 10 million tonnes. To be sure, this is not a bullish factor. It is, however, where the bullish factors end.

Actually, a look at the Indian market as a whole paints a somewhat different picture. On average, India produces roughly what it consumes each year. Early forecasts for the 2001-02 crop year are calling for a drop in production of about 3 million tonnes, or 15%, because of disappointing weather. The USDA attaché in India estimates that consumption will grow by 5%, to 18.7 million tonnes, leaving the country with a deficit of 4-5 million tonnes. It already exported about 1 million tonnes of the carryover stocks this past year. Suddenly, India's inventories are not so burdensome. It has never participated in the export market in a significant way, allowing any surpluses to accumulate, which now seems to have been a rather prudent policy.

The poor weather in south-central regions of Brazil – where the bulk of the crop is grown – continues to play havoc with total crop estimates. The Indian export news overshadowed the Brazilian situation, which in our opinion is of great greater importance. As illustrated, we're skeptical about how much India will really make available for the export market from here on in. Brazil, however, has been the largest supplier of sugar to world trade for years. Last season's disastrous crop slashed exports. The 2001-02 crop was expected to be a recovery year. While the crop will probably be slightly better than 2000-01 – the latest estimate by the USDA calls for an increase of 4.4% – it will come in far shy of the early forecasts for a recovery of 15%-20%.

The European Union is the world's second-largest exporter. Many areas had difficulty getting the beet crop in on time which has resulted in early forecasts for a 2001-02 crop that will be 2 million tonnes smaller than this season's crop. This will make a further dent in export availability.

F.O. Licht is forecasting a slightly larger 2001-02 global crop, and the USDA is calling for a drop of 2.5 million tonnes. Either way, it is a disappointment for a year that was expected to compensate for the poor crops of 2000-01. Prices are hovering at levels that provide little incentive to increase sugar output for producers who do not benefit from government subsidies and are barely eking out a profit. We're stopped out but remain friendly.

[June 1, 2001]

STRATEGY: *We liquidated our long July sugar positions as per Flash Update of May 18. Stay tuned.*

Chart 5 – Cocoa: Spot to 12-month spread

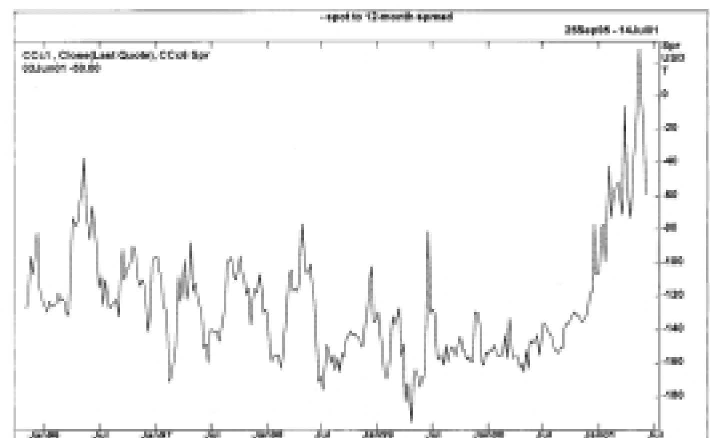


Chart courtesy of *Reuters*

HOTLINE UPDATE

Friday, May 4, 2001:
Good afternoon for Friday, May 4, 4:45 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are short July silver, with our stop at 455, long July cocoa, with our stop at 930, and long July sugar, with our stop revised to 8.50. All stops are close only.

Friday, May 11, 2001:
Good afternoon for Friday, May 11, 4:45 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are short July silver, with our stop revised to 445; long July cocoa, with our stop revised to 975; and long July sugar, with our stop revised to 8.80. All stops are close only.

***Flash Update* – Wednesday, May 16, 2001:**
Good afternoon for Wednesday, May 16, 2:35 pm. This is a Flash Update. We have covered our short July silver position at 445.50.

***Flash Update* – Friday, May 18, 2001:**
Good morning for Friday, May 18, 11:35 am. This is a Flash Update. We have liquidated our long July sugar position at 8.80.

Friday, May 18, 2001
Good afternoon for Friday, May 18, 4:30 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long July cocoa, with our stop at 975. All stops are close only.

***Flash Update* – Monday, May 21, 2001:**
Good morning for Monday, May 21, 11:05 am. This is a Flash Update. We have purchased July wheat at 266, placing our initial stop at 236, close only.

***Flash Update* – Thursday, May 24, 2001:**
Good morning for Thursday, May 24, 10:00 am. This is a Flash Update. We have sold short June mini S&P at 1290.50, placing our initial stop at 1320.50, close only.

***Flash Update* – Friday, May 25, 2001:**
Good afternoon for Friday, May 25, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long July cocoa, with our stop at 975; long July wheat, with our stop revised to 251; and short June mini S&P with our initial stop at 1320.50. All stops are close only.

***Flash Update* – Wednesday, May 30, 2001:**
Good morning for Wednesday, May 30, 10:45 am. This is a Flash Update. We have liquidated our long July cocoa position at 975.

***Flash Update* – Thursday, May 31, 2001:**
Good morning for Thursday, May 31, 9:05 am. This is a Flash Update. We have two new recommendations. We have purchase September T-bonds at 99-01, placing our initial stop at 98-00, close only, and we have sold short August crude oil at 28.64, placing our initial stop at 29.75, close only.

Friday, June 1, 2001:
Good afternoon for Friday, June 1, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long July wheat, with our stop revised to 261; short June mini S&P, with our stop revised to 1270; long September T-bonds, with our stop revised to 98-30; and short August crude oil, with our stop revised to 29.25. All stops are close only.

Friedberg's Focus on Futures is published by Friedberg Commodity Management Inc., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3. Contents copyright © 2001 by Friedberg Commodity Management Inc. All rights reserved. Reproduction in whole or in part without permission is prohibited. Brief extracts may be made with due acknowledgement.

Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1910
New York, N.Y. 10005
(212) 943-5300

All statements made herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate.
Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

The U.S. broker-dealer, Friedberg Mercantile Group, Inc. NY, takes full responsibility for the contents of this market letter.
U.S. residents wishing to effect any transactions in any security discussed in this report
should contact Friedberg Mercantile Group, Inc. NY, toll-free at 1-800-474-2663.