FRIEDBERG'S

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Sharply lower Brazilian coffee production for 2003-04 may bring closure to the bear market

Coffee prices have been in a bear market since they peaked in 1997 at $2.70 per pound. After Brazil recovered from frost-reduced crops in the mid-1990s, production in the world's largest producer rose sharply. Output increased from an average crop size of between 25 and 30 million bags in the first half of the decade, to the record 2002-03 crop of over 50 million bags.

Production in the traditional number-two producer – Colombia – has tailed off since it grew several bumper crops in the early part of the 1990s, but it has consistently yielded an average crop of over 10 million bags, or about 10% of global output.

Vietnam has become a major player in the industry. In the early 1990s, Vietnamese production accounted for only 2.5% of global output. By the 2000-01 season, it was producing over 15 million bags, or 13% of global output, displacing Colombia as the world's second-largest producer. The 2000-01 crop was a record harvest for Vietnam. The 2001-02 (12 million bags) and 2002-03 (10 million bags) crop years were not as bountiful, because of a reduction in both acreage and yields.

Total global production has grown significantly in recent years. Output for 2002-03 is estimated at 125 million bags, compared with an average of 110 million bags in the previous 5 seasons.

Demand in the coffee market is often measured in per capita kilogram consumption in Western countries. As such, demand has stagnated since the mid 1990s at about 4.6 kilograms. The large swings in price that we witnessed over the past decade have been independent of changes in demand, because there were none. Rather, bull and bear markets have been determined by significant shifts in output.

Looking ahead to the 2003-04 season, prices have fallen enough to discourage producers from growing huge crops. Exact statistics are hard to come by, but it is clear that prices are below the cost of production in many production regions.

Early estimates of the 2003-04 Brazilian crop show a dramatic drop in output. The range of forecasts is a bit wild at the moment, with government estimates of 28 million bags and private analysts looking for up to 35 million bags. Either way, we are looking at a drop in supplies of at least 15 million bags.

Coffee grows in a biannual cycle, and the dropoff in output has more to do with this horticultural matter than it does with faltering investment in plantations because of low prices. Regardless, it leaves the market vulnerable. We are headed into the Brazilian frost season, which extends from late May through August. The frost of the 1995-96 crop, which slashed output by 11 million bags, or 40%, from the previous year, should be a reminder of the extent of damage that can be inflicted on crops.

Still, the market heads into this season of lower production with ample supplies on hand that were built up during the past few years of overproduction. According to the USDA, global ending stocks at the end of the 2002-03 marketing year will stand at 31 million bags, or 25% of consumption. This compares with an average for the previous 5 years of 23 million bags, or 21% of consumption.

The market has already priced in some of the dynamics of a much smaller crop. Prices have rallied from 40¢ to 60¢ per pound since the beginning of 2003. As illustrated, lower production does not necessarily mean lower available supplies, because of the low growth rate of consumption and rel-

Inside

Canadian Dollar: Singing loonie tunes 2
Cocoa: Ivorian output unaffected by civil war 3
Soybeans: Demand shows no signs of letting up....4
Hotline Update 6

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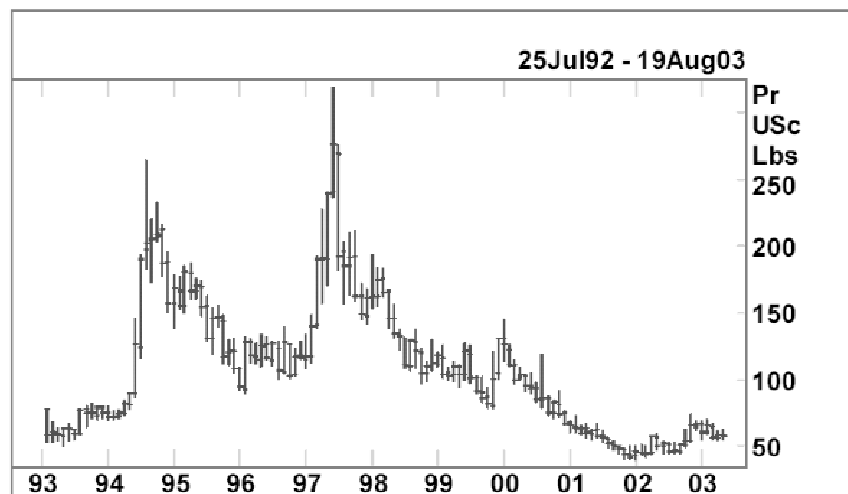
atively high carryover stocks. Nevertheless, a glance at Chart 1 shows that even after the rally we've seen over the past few months, market prices are very depressed in historical terms. Smaller crops are a natural outgrowth of farmers withholding expensive fertilizers and opting for alternative crops, and we expect that such trends will continue. As the market builds a base, we will be looking for low-risk opportunities to jump on the long side. *[April 16, 2003]*

CURRENT STRATEGY: *Remain long July coffee as per Flash Update of April 29. Raise stops to 64.45, close only.*

Chart 1 – Coffee, monthly nearest contract



Courtesy Reuters

CANADIAN DOLLAR

Singing loonie tunes

A vast majority of people active in the currency-trading industry in 2003 would have to consult history books to find the Canadian dollar changing hands at par with its US counterpart. They might be surprised to find that the currency even commanded a premium over the greenback for many years. The first jolt that sent the Canadian dollar into a decades-long bear market came in 1976, when the market first adjusted to the reality that Canada's second most populous province had begun a march towards secession. Capital flight ensued, and the bear was here to stay.

Over the past few months, however, the Canadian dollar has experienced a strong rally from the depths of its bear market lows (Chart 2). There have been many rallies over the years, all of which have lost momentum and seen the currency return to the US 63¢ level. Is there any reason to believe that this rally might be different?

On the surface, Canadian dollar strength can be viewed in terms of general US dollar weakness. The US dollar has fallen 30% against the euro and 20% against the basket of trading partners represented in the Dollar Index. But the reasons for US dollar weakness against European currencies have never been crystal clear. European economies have lagged the US and continue to do so. The situation has been described by many currency analysts as a choice between the lesser of two evils, rather than a flight to quality.

Table 1 - GDP growth for G7 countries

	2003	2003*
Canada	3.4%	2.7%
US	2.4	2.5
UK	1.8	2.1
France	1.2	1.2
Italy	0.4	1
Japan	0.3	1
Germany	0.2	0.3

**OECD forecast*

The Canadian economy, on the other hand, has been the star performer among G7 countries, growing by 3.4% in 2002. This compares with the distant second-place member, the US, whose GDP grew by only 2.4% (Table 1). Although most analysts agree that the Canadian economy will not be able to sustain the growth it saw in 2002, it is still expected to be the strongest in the group.

The Bank of Canada (BOC) has been aggressive because it has been faced with inflationary pressures. The most recent CPI figures for Canada showed the core rate of inflation running at an annualized rate of 2.9%, significantly above the BOC's own 2% inflation target. On April 15 it raised the

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overnight lending rate to 3.25%. The bank's semi-annual *Monetary Policy Report*, released on April 23, addressed the issue, stating, "...the Bank continues to believe that further reductions in monetary stimulus will be necessary over time to return inflation to its 2 per cent target..."

The Fed has been able to chop rates down to 40-year lows because it is working with a core rate of inflation of only 1.7%. The US equivalent of the BOC's overnight lending rate, the Fed Funds rate, sits at 1.25%. The 200-basis-point spread between the interest rates of the two countries (Chart 3), however, is not quite as attractive after adjusting for inflation. Still, short-term traders are not as concerned about real rates, and the hefty premium on bank deposits paid by Canadian paper is a bullish factor for the currency.

The Canadian dollar has been undervalued for a long time. One gauge of this undervaluation is *The Economist's* well-known Purchasing Power Parity indicator, which prices a McDonalds hamburger in countries around the globe. Big Macs are a lot cheaper in Canada than they are Tokyo.

In addition, the US62.80¢ low in the Canadian dollar was touched in February 2002, shortly after the final tranche of legislation went into effect, which raised the ceiling for foreign content in retirement funds to 30% from 20%. In the years leading up to the increase in permissible foreign content there was significant pressure on the currency as pension funds liquidated Canadian dollar-denominated securities.

Finally, in Quebec's recent provincial elections, the federalist Liberals defeated the long-time governing party, the separatist Parti Québecois, by a solid majority. The PQ's defeat has removed a key impediment to Canadian dollar strength, bringing with it the perception, at least, of increased political stability – an important signal for foreign investors. That, in turn, could now add another dimension to the dollar's bull run.

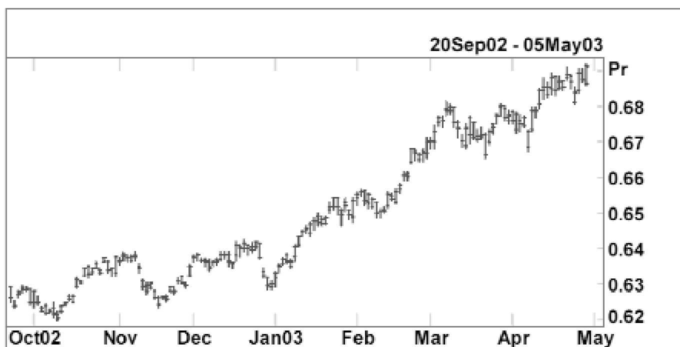
The speculative community is heavily long the Canadian dollar, and as such, we can be sure that there will be some wild gyrations along the way. A case in point is the economic fallout associated with SARS. Last week, The World Health Organization (WHO) issued an advisory against travel to Toronto, which sent the Canadian dollar on a wild ride and a two-thirds-of-a-cent drop. When the WHO lifted the ban a few days later, we saw the currency close at a fresh three-year high.

SARS and its economic impact are obviously very serious matters, but the fabric of the Canadian economy has strengthened considerably over the past couple of years and is not likely to be shaken by what we hope is a short-term and correctable situation. The major trend for the Canadian dollar is up, and the move is rooted in solid fundamentals.

[April 29, 2003]

STRATEGY: *Remain long June Canadian dollar as per Flash Update of June 3. Raise stops to 67.25, close only.*

Chart 2 – June Canadian dollar



Courtesy Reuters

Chart 3 – Spread between Canadian and US short-term rates

COCOA

Ivorian output unaffected by civil war

E.D.&F. Man, *the* authoritative voice on the cocoa market, released its April supply/demand situation report on April 22. It was a very bearish report and dispelled many bullish notions the street – including us – was working with.

Ivorian arrivals reached 1.05 million tonnes by the end of March. Speculation that the tense situation caused by the civil unrest had reduced yields because of inadequate drying of beans was inaccurate. Yields were actually 5% to 7% higher than normal. Throw in a better-than-average mid-crop of 250,000 tonnes, and the total 2002-03 Ivorian crop will reach 1.3 million tonnes, 60,000 tonnes larger than last year, and 125,000 tonnes higher than Man's December report.

Although inclement weather in the world's second largest producer hit crop yields hard, the estimate for Indonesian output was raised significantly, by 65,000 tonnes from the December estimate, to 485,000 tonnes. Estimates for output

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of other producers were largely unchanged from Man's December report.

As a result of these two important revisions to production, 2002-03 global output will grow by 263,000 tonnes, or close to 10% over last season. This revision is 213,000 tonnes above the December forecast.

Not all of this was news to the market. In early April, trade sources had already indicated that arrivals at Ivorian ports had reached 1.04 million tonnes. The bulk of the fresh news contained in the Man report was the forecast for a much larger than normal mid-crop, which is typically in the 180,000 to 200,000-tonne range.

On the consumption side, grindings recovered in 2002-03. The 5% increase, however, paled in comparison with the 10% growth in output. This will leave the market with a 23,000-tonne surplus, the first surplus since the end of the 1999-00 season and a rather dramatic shift from the 133,000-tonne deficit forecast by Man in December. Ending stocks will be about 1.1 million tonnes, or 36.7% of consumption, a substantial distance from the 30%-of-consumption level that we believed was necessary to sustain the bull market. No question that the complexion of this market has been altered significantly.

Man expects grindings to remain steady, and early indications bear this out. The pan-European grind for the first quarter was up 2%, and the US grind was 2.76% higher, both roughly in line with trader's expectations.

On the whole, though, we must say that the outlook is disappointing for bulls. The anticipated crop problems in the Ivory Coast were the basis of the bullish case. Period. With this argument gone, it is difficult to see cocoa prices being maintained at their current levels of around $2,000 per tonne.

It is a bit strange that the market took the Man report in stride. The market sold off sharply on the day the report was released to the press, with July cocoa tumbling $66 per tonne (Chart 4). Since then, however, the market has been rallying, tacking on a $113 per tonne, to close at a 6-week high. Furthermore, during the recent rally, the July/September spread has widened noticeably, by about $60 per tonne (Chart 5).

One possible explanation of the market's strength in the face of what seem indisputable bearish fundamental developments is the activity of commodity funds. Typically, the funds are less motivated by supply/demand fundamentals than by technical analysis. They had already begun to cover their massive short position when the market failed to follow through on the mid-April break below the $1,850 support level. Commitment of Traders data show that in the most recent reporting period, funds had covered 2,300 contracts, but were still left with a net short position of 26,500 contracts.

The bull market may very well be over. We believe that the lofty prices we are looking at no longer fairly represent the evolving supply/demand fundamentals. The preceding points about the market's resilience will keep us away from the short side for now, but ultimately we will be looking for a sharp drop in prices. *[April 30, 2003]*

STRATEGY: *Stay tuned.*

Chart 4 – July cocoa

Courtesy Reuters

Chart 5 – July/September spread

Courtesy Reuters

SOYBEANS

Demand shows no signs of letting up

Soybean prices rose to five-year highs this week (Chart 6). The April USDA supply/demand situation report revised the estimate for US 2002-03 ending stocks downwards by 400,000 tonnes, to 3.94 million tonnes, or 5.2% of consumption, the lowest estimate of the marketing year. Because demand has been so strong, supplies are actually tighter than they were at the end of the 1996-97 season, when the carry-over was 3.59 million tonnes, or 5.4% of consumption.

The March 31 planting intentions report was initially considered bearish. Traders were expecting 72.43 million acres to be planted to soy, but were surprised to see the actual figure come in at 73.2 million acres. At the time, it seemed that this was going to set the tone for the near term, putting put a lid on prices that already appeared rich, particularly in light of the

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expected tidal wave of South American beans that were about to hit the market. In terms of the street's guesstimates the revisions was a negative development for prices. But let's keep in mind that this will still be the lowest planted acreage since 1998. Indeed, the market had little regard for the bearish implications. July soybeans have since rallied by 50¢ per bushel.

The current leg of the bull run can be attributed primarily to two factors.

First, the USDA – with an eye to the record crops being grown in South America – underestimated demand for US exports. The April report increased the estimate for US sales to 27.08 million tonnes. Its estimate has grown each month since August, when it was forecasting exports of only 22.3 million tonnes.

In all likelihood, the estimate is still too small. With several months left to the marketing year, export commitments stand at 27.4 million tonnes. Not only are commitments running ahead of the USDA final projection, they are running ahead of last year's pace of 26.69 million tonnes at this juncture of the marketing year.

Final exports last season reached 28.92 million tonnes, which means that the USDA expects South American sales to dominate the market from here on in. This would involve not only a complete – and unprecedented – halt to new sales through August 31, but a slew of cancellations.

Of course, this will be unprecedented precisely because we are dealing with a fresh set of supply dynamics as overwhelming South American crops become available. But we have not yet seen net cancellations in the weekly sales reports. For that matter, we remain in excellent position to meet and perhaps even exceed last year's exports. Shipments stand at 24.9 million tonnes and are actually bigger than they were at this time last year, by close to 1 million tonnes. Over the past few weeks, shipments have averaged about 350,000 tonnes. Average weekly shipments for the 18 weeks remaining in the marketing year required to reach the USDA target would be just over 100,000 tonnes.

The other issue that has underpinned the recent strength in prices is the emergence of crop disease in Brazil. In mid-April news wires started carrying stories of Asian rust affecting Brazilian crops. Crop loss was estimated at over 2 million tonnes and in itself is not too significant. The crop would be reduced to 49 million tonnes, still 13% larger than last year's crop.

Ideas that a chink could be developing in the armor of South American production, however, had – at the very least – a bit of a psychological effect. After all, we've seen month after month of increases in estimates of both Brazilian and Argentinean production. The market had accepted that the demand side was bullish, but gave little consideration to the possibility of any assistance from the supply side. There was even talk that the airborne disease could reach North America.

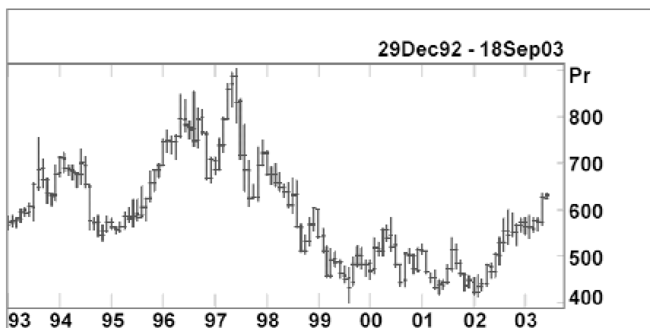
A serious flood in Sante Fe province in Argentina made the grain headlines this week. The region is home to the second largest soy area in the country. Adverse effects will be minimal, though, because most of the soy area is north of the devastated area, and besides, 70% of the crop has been harvested.

We chose to buy new-crop November (Chart 7) because, as illustrated, the market has operated under the auspices of several miscalculations (US exports, an infallible South American crop). Pricing new-crop months 12% below spot prices assumes that demand will remain constant and that Brazil and Argentina will take care of business until the US crop is harvested in the fall. It also leaves little room for any crop accidents with the US crop. Perhaps, but the insatiable demand that has all but cleaned the US out of beans has shown no signs of abating.

The new-crop discounts are attractive and should allow us to ride this bull market comfortably through the spring-planting and the summer-growing seasons. *[May 2, 2003]*

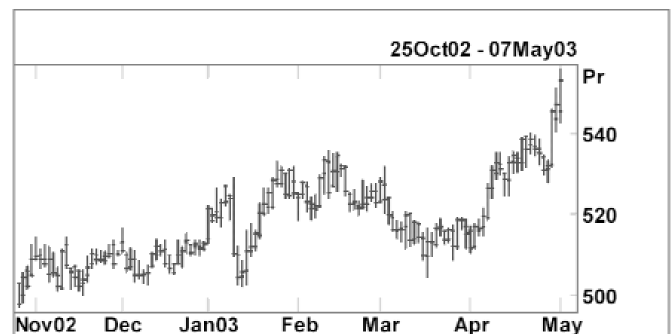
STRATEGY: *Remain long November soybeans as per Flash Update of April 28. Maintain stops at 506, close only.*

Chart 6 – Monthly soybeans



Courtesy Reuters

Chart 7 – November soybeans



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HOTLINE UPDATE

***Flash Update* – Monday March 31, 2003:**
Good morning for Monday, March 31, 9:10 am. This is a Flash Update. We have purchased June gold at 336.20, placing our initial stop at 320, close only.

Tuesday, April 1, 2003:
Good morning for Tuesday, April 1, 9:30 am. We have sold short June mini S&P at 844, placing our initial stop at 890, close only.

Thursday, April 3, 2003:
Good morning for Thursday, April 3, 10:10 am. We have revised our stop on our short June mini S&P to 900, close only, replacing our stop at 890, close only.

Friday, April 4, 2003:
Good afternoon for Friday, April 4, 4:20 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On March 31 we purchased June gold at 336.20; on April 1 we sold short June mini S&P at 844.25; we are currently long May cotton at 57.30, with our stop at 53.00; short May sugar at 8.00, with our stop revised to 7.75; long July cocoa at 1989, with our stop revised to 1899; long June gold at 336.20, with our initial stop at 320; and short June mini S&P at 844.25, with our stop revised to 900. All stops are close only.

***Flash Update* – Tuesday, April 8, 2003:**
Good morning for Tuesday, April 8, 9:40 am. This is a Flash Update. We have purchased June Canadian dollars at 0.6726 and June euro currency at 1.0628, placing our initial stops at 0.6610 and 1.0595 respectively. Both stops are close only.

***Flash Update* – Friday, April 11, 2003:**
Good morning for April 11, 11:35 am. This is a Flash Update. We have liquidated our long July cocoa position at 1886.

Friday, April 11, 2003:
Good afternoon for Friday, April 11, 4:20 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On April 8 we purchased June Canadian dollar and June euro currency; on April 11 we liquidated our long July cocoa position; we are currently long May cotton at 57.30, with our stop at 53.00; short May sugar at 8.00, with our stop at 7.75; long June gold at 336.20, with our stop at 320; short June mini S&P at 844.25, with our stop at 900; long June Canadian dollars at 0.6726, with our initial stop at 0.6610; and long June euro currency at 1.0628, with our initial stop at 1.0595. All stops are close only.

***Flash Update* – Monday, April 14, 2003:**
Good morning for Monday, April 14, 11:00 am. This is a Flash Update. We have purchased July corn at 240.25, placing our initial stop at 230, close only.

***Flash Update* – Thursday, April 17, 2003:**
Good afternoon for Thursday, April 17, 12:05 pm. This is a Flash Update. We have covered our short May sugar at 7.47.

Thursday, April 17, 2003
Good afternoon for Thursday, April 17, 4:25 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On April 14 we purchased July corn at 240.25; on April 17 we covered our short May sugar position at 7.47; we are currently long May cotton at 57.30, with our stop revised to 56.90; long June gold at 336.20, with our stop at 320; short June mini S&P at 844.25, with our stop at 900; long July corn at 240.25, with our initial stop at 230; long June Canadian dollars at 0.6726, with our stop revised to 0.6650; and long June euro currency at 1.0628, with our stop at 1.0595. All stops are close only.

***Flash Update* – Tuesday, April 22, 2003:**
Good afternoon for Tuesday, April 22, 2:00 pm. This is a Flash Update. We have rolled over our long May cotton position into July at 2.37 July over. Our stop has been revised to 59.20 close only.

***Flash Update* – Tuesday, April 22, 2003:**
Good afternoon for Tuesday, April 22, 4:10 pm. This is a Flash Update. We have covered our short June mini S&P position at 911. We repeat our Flash Update of earlier today where we rolled over our long May cotton position into July at 2.37 July over. Our stop has been revised to 59.20 close only.

***Flash Update* – Thursday, April 24, 2003:**
Good afternoon for Thursday, April 24, 3:20 pm. This is a Flash Update. We have liquidated our long July cotton position at 57.85.

Friday, April 25, 2003:
Good afternoon for Friday, April 25, 4:35 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On April 22 we rolled over our long May cotton position into July at 237 July over, and covered our short June mini S&P position at 911; on April 24 we liquidated our long July cotton position at 57.85; we are currently long June gold at 336.20, with our stop at 320; long July corn at 240.25, with our stop at 230; long June Canadian dollars at 0.6726, with our stop at 0.6650; and long June euro currency at 1.0628, with our stop at 1.0595. All stops are close only.

***Flash Update* – Monday, April 28, 2003:**
Good afternoon for Monday April 28, 1:40 pm. This is a Flash Update. We have purchased November soybeans at 530.50, placing our initial stop at 506, close only.

***Flash Update* – Tuesday, April 29, 2003:**
Good morning for Tuesday, April 29, 10:40 am. This is a Flash Update. We have purchased July coffee at 64.45, placing our initial stop at 58.00, close only.

***Flash Update* – Tuesday, April 29, 2003:**
Good morning for Tuesday, April 29, 11:20 am. This is a Flash Update. We have liquidated our long July corn position at 229.75. We repeat our Flash Update of earlier this morning where we purchased July coffee at 64.45, placing our initial stop at 58.00, close only.

Friday, May 2, 2003:
Good afternoon for Friday, May 2, 4:40 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On April 28 we purchased November soybeans at 530.50; on April 29 we liquidated our long July corn position at 229.75, and purchased July coffee at 64.45; we are currently long June gold at 336.20, with our stop at 320; long November soybeans at 530.50, with our initial stop at 506; long July coffee at 64.45, with our stop revised to 63.00; long June Canadian dollars at 0.6726, with our stop revised to 0.6725; and long June euro currency at 1.0628, with our stop revised to 1.09. All stops are close only.

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