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Wheat: A return to the deficit years

The honeymoon is over.

Global wheat output fell for six consecutive years between the 1998-99 and 2003-04 seasons. Global population continued to grow, however, and by the end of the 2003-04, inventories had been drawn down to their lowest level in three decades. Wheat prices bottomed below \$2.40 per bushel in the late 1990s, then with global supplies dwindling, rallied to above \$4 per bushel twice over the next 4 years (Chart 1).

In 2004-05, producing countries responded to the attractive prices, and production snapped back to 626 million tonnes, up 13% from the previous season. This past season, output reached only 616 million tonnes, but it still seemed that producers would collectively maintain the new plateau above 600 million tonnes.

It has therefore been quite disappointing to observe the progress of Northern Hemisphere winter wheat crops.

A look at the short-term chart of July Kansas City wheat (winter wheat) shows that the current leg of this bull market began justifiably in the days following the January 12 USDA's early estimate of 2006-07 winter wheat acreage (planted in autumn 2005), which typically comprises over 70% of the US wheat crop. Although the figure was 41.36 million acres, 1 million acres above 2004-05 acreage, it was one of those situations where the report was a *bona fide* surprise to the market. The average analyst guesstimate coming into the report was 1 million acres higher at 42.39 million acres.

While the bull run began with smaller-than anticipated acreage, it was supported by a very disappointing outlook for crops. At this point of the growing season, the USDA does not provide one rating for all wheat producing states. The first such report is not available until the first week in April. But each state publishes its own monthly ratings, and conditions for the major growing states have been very poor. Above-average temperatures and below-average precipitation have left fields dry, with soil moisture levels insufficient to achieve optimum yields.

The good-to-excellent portion of the crop in Kansas – the largest in the US – represents only 27% of the total crop, down from 52% last month and 74% at this time last year! In the case of Oklahoma, it doesn't even pay to bother with the good-to-excellent side. The poor-to-very-poor portion is 70%, up from 58% last month and only 4% at the same time last year. Another important wheat state, Nebraska, has a good-to-excellent rating of 42% compared with 62% last year.

We should bear in mind that conditions at this time of year rarely reflect the final outcome. However, these crop condition figures are quite extraordinary, and perfect weather conditions would be required to turn things around.

Elsewhere, the weather in Russia and Eastern Europe has also been very uncooperative. Winterkill has reduced yields in many regions and is expected to have a significant impact on the final size of the crop.

To account for these developments, on February 23, the International Grain Council (IGC) chopped its previous estimate for 2006-07 global production by 7 million tonnes, to 588 million tonnes, down sharply from 2005-06 output of 615 million tonnes.

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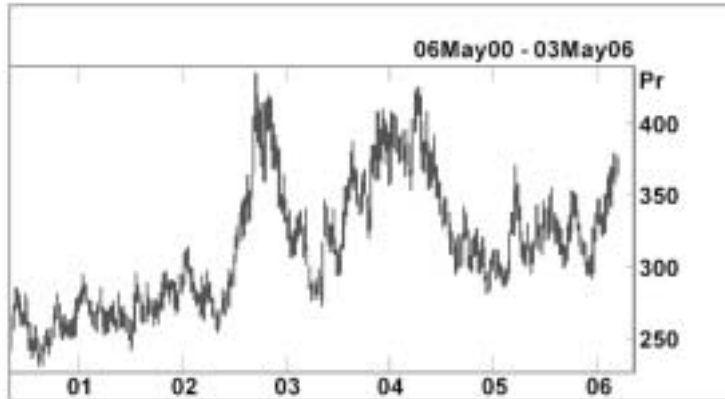
The “production boom,” then, actually lasted only one season. This returns the wheat market to the years of global production/consumption deficits and further depletion of inventories. In fact, only the 2004-05 season saw a global surplus. The IGC is also forecasting a 13-million-tonne drop in consumption, to 605 million tonnes. Still, this will leave a deficit of 17 million tonnes, and stocks as a percentage of consumption would fall to 19.8%, a modern-day record.

US exports, a key gauge of world demand, are forecast

to be 6% below last year. The current commitment and shipment data support this estimate. But this rally is not being fueled by the demand side. As illustrated, the outlook for the new crop year is carrying this bull on its own.

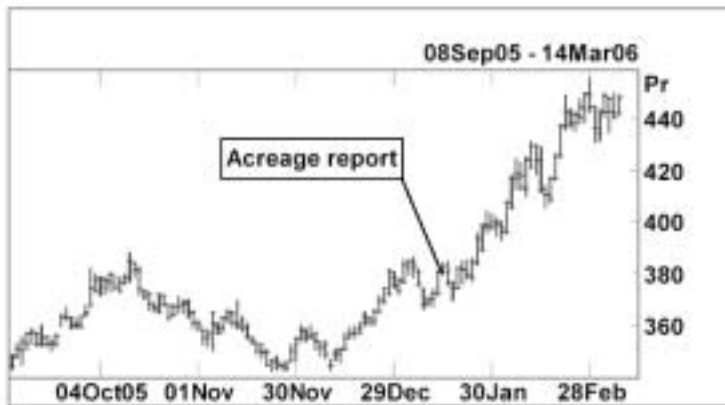
While US hard red winter wheat is the one in most trouble, the potential exists for supply shortages for all varieties, including the lower-quality feed wheat grown in Eastern Europe. The market has had quite a move, but we advise maintaining long positions and establishing new ones on setbacks. *[March 9, 2006]*

Chart 1
Weekly CBOT wheat,
nearest contract



Courtesy Reuters

Chart 2
Daily Kansas City wheat



Courtesy Reuters

SUGAR

The bull pauses

The first phase of the transition of the sugar market from its status as a primarily food-only industry to a food-and-fuel industry is complete. Amidst a speculative frenzy, prices spiked past what was likely fair value (for the moment) but have now withdrawn from the close-to-20¢-per-pound peak and are in the process of consolidating the still-extraordinary gains.

Market participants have a lot to digest. The world’s biggest producer used slightly more than half its cane output to produce ethanol in 2005-06, and that ratio is expected to continue to grow in favor of ethanol for the new crop, which is now being harvested. As bullish as that may seem for sugar prices, recent developments in Brazil and elsewhere are commensurate with the pullback in prices.

On March 1, the Brazilian government lowered the minimum ethanol-to-petroleum ratio to 20% from 25% in response to overheating demand and rising prices. Ethanol consumption has skyrocketed over the past couple of years because of the price advantage over petroleum. This strong demand has tightened supplies of ethanol, however, and although most new cars sold in Brazil are “flex cars” that can run on any combination of the two fuel types, a combination of the government measure and the shrinking price advantage is expected to cause ethanol usage to fall by 10% until prices come back into line.

While explosive growth of the ethanol market in Brazil was the main reason for the bull market, the initial move off the 5¢-per-pound lows was actually triggered by two consecutive Indian crop failures.

Output in 2003-04 and 2004-05 dropped to about 13 million tonnes from crops that reached close to 20 million tonnes earlier this decade. But production has recovered to 18.5 million tonnes during the current season, and the coming 2006-07 crop is expected to jump to between 21 and 22 million tonnes. High prices have inspired farmers to substitute sugar cane for other, less-profitable, crops *en masse*. This estimate is based on planted acreage and is of course subject to the cooperation of the weatherman.

Although, the Indian situation is clearly a bearish development, we believe that the days of huge Indian carryover stocks are over, despite the return to normal-sized crops. For years, year-end inventories were equal to well over 50% of Indian consumption. Two factors will not allow this to happen in the foreseeable future. First, the export market has been liberalized, and India is expected to export 1.5 million tonnes in the coming marketing year. Second, while still in its

infancy, the ethanol market is growing. Some regions already have a government mandated 5% ethanol auto fuel blend. It is only a fraction of the Brazilian market, but ethanol output is expected to increase from 450 million litres this marketing year to 615 million litres in 2006-07. Between exports and some leakage to the fuel market, domestic food consumption is about balanced and leaves little, if any, room for India to rebuild its once mighty stockpiles.

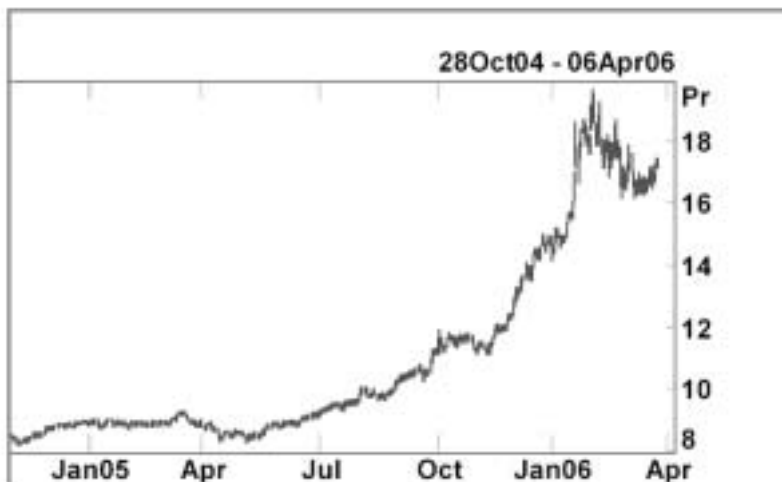
Prices may have found some support from the powerful cyclone that hit Australia on March 20, which reportedly wiped out about 10% of the crop, or about 500,000 tonnes. Australia is the world’s third largest exporter of sugar, and if these early estimates are accurate, it will certainly have some impact on availability in Australia’s traditional export markets.

On March 17, F.O. Licht released its revised estimate of the 2005-06 global balance sheet, showing production slightly lower and consumption slightly higher. Stocks as a percentage of consumption dropped to 39.2%, from the previous estimate of 40.82%. This compares with 40.96% in 2004-05 and 45.79% in 2003-04.

As was pointed to at the beginning of this article, the market has made the initial adjustment for the new realities involved in sharing sugar crops with the fuel market. The world’s sugar producing countries will have to grow more sugar. All eyes will be on the new crops, which will be harvested in the coming months, to see if the supply side of the equation is catching up to the demand side.

We definitely advise traders to continue trading from the long side, but with a conservative approach, realizing that this market will remain very volatile and will provide ample entry opportunities. [March 28, 2006]

Chart 3 – May sugar



Courtesy Reuters

SOYBEANS**Ample supplies and ho-hum demand**

After a sharp rally in December, soybean prices have resumed their downtrend. The fundamentals on all fronts are mostly bearish.

US exports for the current 2005-06 marketing year have been dismal. Commitments as of the most recent weekly report stand at 20.72 million tonnes, 22.5% below last year at this time. The USDA estimate for the season is 24.49 million tonnes, down only 18.4% for the year.

Anecdotal evidence of slowing Asian demand for soymeal exists and is somewhat supported by the recent export statistics. Processors in China are reportedly careful not to over-crush, because they anticipate that fear of bird flu will lower consumption of poultry. Aside from the March 9 weekly export report, which showed an extraordinary combined old and new crop sales tally of 750,000 tonnes, weekly sales have averaged about 500,000 tonnes since the beginning of 2006. Over the past two weeks, however, weekly sales have slowed to about 300,000 tonnes. It is difficult to say whether poultry consumption will suffer. But even if it were to have an impact on consumers' purchasing habits, there would be pork substitution, and hogs eat plenty of protein meal, so ultimately we do not expect an appreciable effect on soybean usage. There are still five months remaining in the marketing year, so we still should be able to hit the USDA target with a return to average weekly sales levels.

In any case, even if we do meet the USDA target, US carryover stocks are expected to be the largest on record. In its March supply/demand situation report, the USDA increased its estimate for 2005-06 ending stocks to 15.37 million tonnes, or 20.30% of consumption. That's up from last month's estimate of 19.9% and a dramatic jump from the bull market inventory levels of 2003-04 and 2004-05 of 4.4% and 8.6% respectively. Even if foreign interest for soybeans were to improve over the coming months, US exporters are in fine shape to meet the demand.

After several years of mid-season disappointments, it seemed for a while that Brazil and Argentina would finally

produce crops that are close to their early-season expectations. The USDA maintained its record 58.5- and 40.5-million-tonne estimates for Brazil and Argentina in this month's report, which is up from 2004-05 output of 53 and 39 million tonnes, respectively. But that is not in the books yet.

Recent South American weather has not been favorable, and *Oil World* has a somewhat more pessimistic outlook. On March 21, it lowered its Brazilian estimate to between 54 and 56 million tonnes, from its February estimate of 56 million tonnes. It lowered its Argentinean forecast to 39 million tonnes, down from 39.7 in its previous estimate.

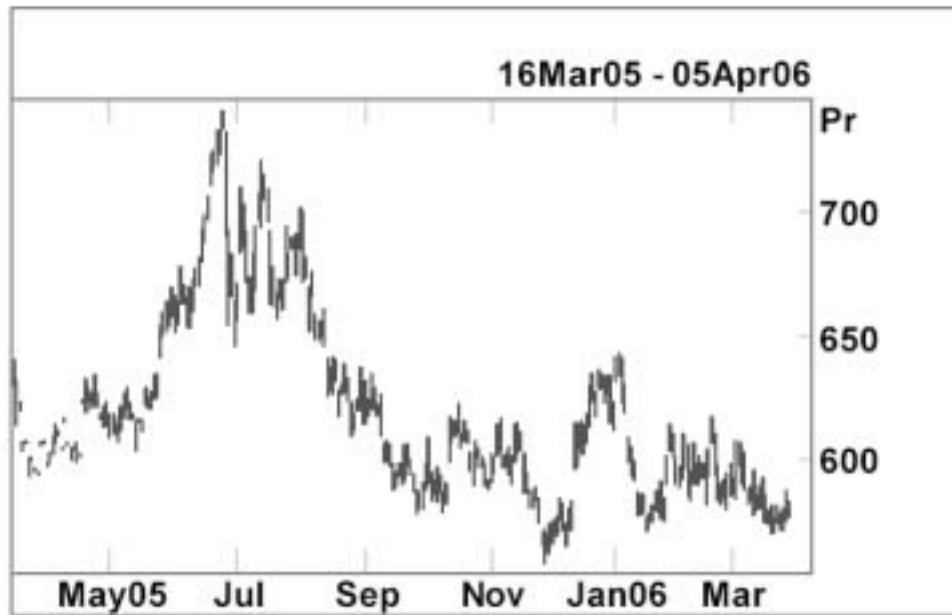
Thus, while South American output will be at record levels, the crops are likely to be smaller than the market was expecting.

On March 31, the USDA will release the results of its US planting intentions survey for the 2006-07 soybean and corn crops to be planted this spring. Soybeans are widely expected to take acres from corn. The USDA forum estimate in February was 74 million acres, up from 72.1 million acres in 2005-06. Private estimates are looking for an even larger amount of new acres. One vital development, though, that could change farmers' intentions is that the price of natural gas fertilizer that is used intensively for corn has fallen substantially and was cited as the principal discouragement for growing corn.

In conclusion, we've illustrated how the world's three largest growers and exporters are well supplied to meet their domestic and export requirements. There has been a downtick in the supply side, which in all likelihood is why prices have not been making new lows, but without support from the demand side, this market cannot go very far. Any bearish supply-side development could push the market to fresh recent lows and beyond. Although soybean prices can definitely head lower, they have already fallen substantially from their bull market highs. Because of that and the fact that we are in a generally bullish commodity environment, we choose not to probe the short side.

[March 29, 2006]

Chart 4 – May soybeans



Courtesy Reuters

CORN

Surprisingly low US acreage and strong demand yield higher prices

The results of the March 31 USDA planting intentions report were completely unexpected. In the weeks leading up to the acreage survey, analysts were slowly raising their estimates. The collapse of natural gas prices brought fertilizer prices down sharply, which would increase profitability of corn crops. The street was way off the mark. The number came in at 78.019 million acres, compared with the average analysts' guesstimate of 80.505 million acres. The low end of the range of guesstimates was 80.091 million acres. In notes accompanying the data, the USDA cited a "...switch to other less input intensive crops," despite the drop in gas prices, as well as dry conditions in the southern Great Plains, as an explanation for the smaller acreage.

The quarterly stocks report released along with the acreage report was as expected with March 1 stocks at 6.987 billion bushels, up slightly from the average analysts' estimate of 6.985 billion bushels.

Assuming that we have ideal weather conditions in the US Midwest and yields are similar to last year's excellent 148 bushels per acre, we are now dealing with 350 million bushels, or about 9 million tonnes, less corn for the 2006-07

marketing than was believed before the report.

It is difficult to say what this will do to the global balance sheet until the USDA weighs in with its first 2006-07 outlook for production in other countries. But the US accounts for close to 70% of total global exports, with Argentina and China the only other significant players. So what happens in the US is crucial for world trade.

In 2005-06, global production and consumption were roughly in balance. If consumption holds steady for 2006-07, which we expect it to, particularly in light of the strong demand we've seen from overseas buyers of US corn lately (more on that below), we make a loose estimate that global ending stocks for 2006-07 would fall to about 17.5% of consumption, compared with 19% the past two years. In 2003-04 ending stocks fell to 16% of consumption – the lowest inventory level in 20 years – and that was tight enough to drive corn prices to \$3.35 per bushel. Less than ideal weather in the US and usage that exceeds 2005-06 consumption would push carryover stocks back to their lows.

In the monthly supply/demand situation report, the USDA responded to the torrid pace of US export commit-

ments and raised its estimate for 2005-06 exports by 1.26 million tonnes, to 48.26 million tonnes. This week's old-crop sales were strong again at 1.038 million tonnes. This brings total commitments to 36.6 million tonnes. With five months left to the marketing year, there is plenty of time to meet the USDA target, with room to spare for the inevitable slump.

Aside from extensive growth in the corn-based ethanol industry (see *Focus on Futures*, March 1), cheap corn prices have also been responsible for an increase in usage of other corn-based products. For example, US demand for high fructose corn syrup, which is a highly efficient substitute for industrial sugar usage, is forecast to grow by 2.7% in 2005-06. The sweetener area in particular bears scrutiny, because we are likely to see continued growth as a result of skyrocketing

sugar prices. Overall, food and industrial use grew by 11.2% in 2005-06.

Commodity funds, which showed little interest in corn for most of last year, put on a massive net-long position from early February through mid-March, which reached 173,000 contracts at its peak. The recent 20¢-per-bushel slide was caused by an abrupt bout of liquidation. From a technical analysis point of view, the market behaved very well on that dip, maintaining a pattern of higher lows that began late last year (Chart 5).

The issue of whether gas prices fell in time to impact the 2006-07 planting season seems to be settled with the planting report. The demand side has been strong all along and shows no signs of weakness. We are at the beginning of a long-term bull market. [March 31, 2006]

Chart 5 – May corn



Courtesy Reuters

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