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Dry weather in Western Africa and robust demand push cocoa prices to multi-year highs

Cocoa prices sliced through the March 2005 \$1,860-per-tonne high this week and continued to rise to \$1,900-per-tonne. There were no extraordinary news items to propel the market to two-year highs, but we've been bullish, so the move came as no surprise to us. Although there have no big changes in the market, whatever developments have taken place have been bullish.

The most important issue that will affect prices over the next several months is the size of the Ivorian crop. The main crop runs officially through the end of March, at which point we begin counting mid-crop arrivals. Until earlier this month, main crop arrivals were running ahead of last year's pace, but have now slipped behind, to 900,000 tonnes, just slightly below the 907,000 tonnes recorded last year at this time. Weekly volumes have dropped off sharply – 4,000 tonnes in the most recent reporting week, compared with 7,000 tonnes last year. With two reporting weeks left, the main crop estimate of 930,000 tonnes that's been bandied about will not be achieved.

On March 21 The International Cocoa Organization (ICCO) forecast that the Ivorian mid-crop – harvested from April to September – would be 310,000 tonnes. This estimate is clearly too high and is probably based on historical theoretical models that have not taken into account recent weather conditions. It's been extremely dry in most regions since January, and private forecasters have been talking about a 200,000 to 250,000-tonne mid-crop. There has been some wet weather over the past week or so, but market action would seem to indicate that we are heading for the lower end of that range.

Although the market does not focus on neighboring Ghana and Nigeria as much as it does on the Ivory Coast, we should bear in mind that the cocoa regions in these countries can share the same climatic patterns, and indeed it has been dry there as well. Production estimates for Ghana and Nigeria tend to be erratic – particularly in Nigeria, where recent press reports put the gap between government and private estimates as high as 200,000 tonnes – so it doesn't usually pay to focus on the actual available data. It is safe to assume, though, that by using Ivorian data as a proxy, output will be down across

the board in West Africa, where at least two thirds of the world's cocoa beans are grown.

On the demand side, European butter ratios have not increased by much over the past couple of months, but are holding steady at 2.75 times the London spot price.

First-quarter grind statistics for the US and Western Europe will be released throughout April. Collectively, grindings in Western countries were up close to 6% in the fourth quarter of 2006, and it will be very important to see if there has been any follow-through of this strength, because analysts are still using a demand growth rate of about 2.5% to 3% in their balance sheets. Another strong quarter will provide confirmation that the rally to \$1,900 per tonne is well warranted, because increased consumption will send the estimate for the year-end deficit to levels we have not seen in years.

The most bullish estimate for the global production/consumption balance is a 250,000-tonne deficit. However, if grinding statistics continue at last quarter's pace and the current West African mid-crop estimates come in at the low end, we'd be much closer to a 400,000-tonne deficit. This would slash global carryover stocks from 53% as a percentage of consumption at the end of 2005-06 to about 41% at the end of the current marketing year.

When cocoa prices touched \$2,400 per tonne back in

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2002, much of the excitement was tied to the brewing civil unrest in the Ivory Coast, which never materialized as a hindrance to output. Ivorian production reached record levels in subsequent years. Although we've seen tighter balances –

even in recent history – we have not seen the supply and demand sides both heading in bullish directions quite the way they have in the current environment.

Remain long. [March 28, 2007]

Chart 1 – Daily May cocoa

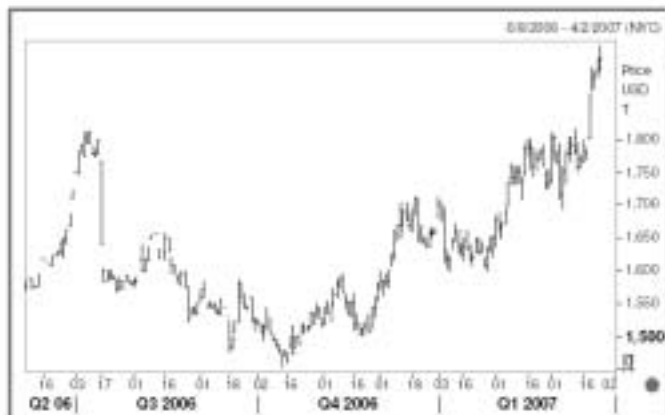
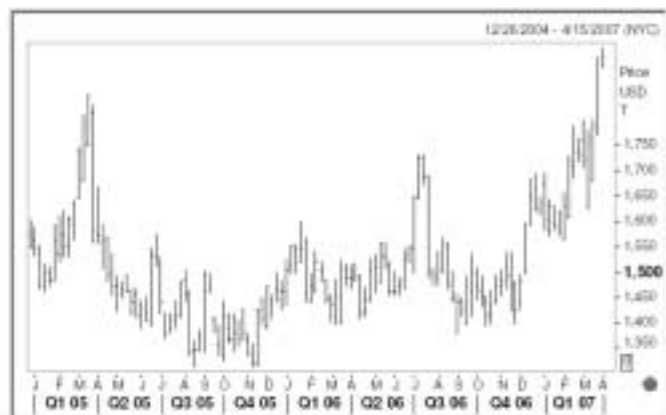


Chart 2 – Weekly nearest contract



Courtesy Reuters

Courtesy Reuters

COTTON

Demand is sluggish, but US acreage set to dive

The price of December (new crop) cotton has been drifting aimlessly between 56¢ and 60¢ per pound since last fall. Most recently, it has climbed up to the middle of the range just prior to the March 30 release of the US 2007-08 planting report. Conflicting underlying fundamental issues make sense of this directionless market.

The 2006-07 global balance shows that we're in a second consecutive season of shrinking inventories. In 2005-06, stocks as a percentage of consumption fell by 3 percentage points from the previous season, to 46.6% of usage. The current estimate for 2006-07 is for a further decline, to 43.1%. But demand has been disappointing, and the final numbers will almost certainly have to be restated.

Earlier in the marketing year, the USDA forecasted that we would see a near repeat of record 2005-06 US exports of 18 million bales. As the season wore on, however, sales did not match expectations, and we are now down to an estimate of 14 million bales. The problem is that recent export statistics indicate that we will need to cut the estimate for annual sales further.

As of the most recent weekly sales report, commitments stand at 64% of projected annual shipments, compared with 73% of final sales at this point last season. There are 19 weeks left in the marketing year, which runs until July 31, and we would have to see average weekly sales of about

250,000 bales to reach the target.

While this is not inconceivable – old-crop export sales remained strong through the end of June last year – it is not common for old crop sales to remain strong for so long, and it will be quite a challenge to meet the USDA estimate. Even if sales pick up, exporters would have to ship close to 500,000 bales weekly, which is well above the late-season pace of last year, when weekly shipments averaged about 400,000 bales.

There is no great mystery to falling US sales. China harvested a record crop of 30.9 million bales in 2006-07, a 4.7-million-bale, or 18%, increase over 2005-06. While domestic consumption purportedly rose in tandem, it should be quite obvious that its bumper crop reduced China's importing needs. According to USDA data, the gap between production and consumption is still vast – about 20 million bales – but the consumption data the USDA uses for China are not nearly as accurate as the US export data. Consider that last year at this time, China had contracted to purchase 7.09 million bales from US exporters and had taken shipments of 4.06 million bales. As of last Thursday's export report, Chinese commitments stood at only 1.7 million bales, with shipments at 1.09 million bales.

High prices for corn and soybeans, however, threaten to neutralize the bearish effects of weak cotton demand. A

massive acreage shift for the 2007-08 season is underway in the US, and many cotton acres will be lost to currently much more profitable soybean crops.

In 2006-07 US farmers planted 15.27 million acres to cotton. The average of analysts' guesstimates heading into the March 30 acreage report for 2007-08 is 12.217 million acres, 20% below 2006-07!

Furthermore, farmers tend to plant their best land to the most profitable crops as well as weighting their input expenditures towards those acres. This, of course, means that the cotton crop harvested this coming fall will not only be 20% smaller than last year based on acreage, but we are also almost certain to see a decline in yields and an even smaller crop.

Last year's 21.73-million-bale US crop was preceded by crops of 23.89 and 23.25 million bales. A rough calculation based on the above information regarding US planting shows that the 2007-08 crop will be no larger than 17 million bales. The US is by far the world's largest exporter, and we slipped by this season because China was largely absent from the import market, as illustrated. Perhaps the economies of Asia and other importing regions will soften, and usage will stagnate. Perhaps not. Either way, it is a near certainty that US production is going to fall dramatically, leaving the market vulnerable to tightness.

We recommend establishing a conservative long position in December cotton. [March 29, 2007]

Chart 3 – Daily December cotton



Courtesy Reuters

WHEAT

The US wheat crop leads global recovery

In our last discussion of wheat on January 29, the gist of our stance was that the bull market was drawing to a close. It would just be a question of time until market participants felt comfortable that production would rebound sufficiently in 2007-08 to tip the global balance sheet back into surplus. As Chart 4 indicates, the market seemed to have had a final fling, with a spike back to the \$5-per-bushel level, but has drifted lower since.

For the US, the winter wheat crop is certainly shaping up as a significant contributor to the recovery. Not since 1996 have US farmers been able to lock in wheat prices at over \$5 per bushel, and they've capitalized on the opportunity. The March 30 acreage report showed that US farm-

ers planted 44.5 million winter wheat acres, 9.6% more than in 2006-07. Total acreage, which includes spring wheat, was up by only 5%, because of a shift of spring wheat acres to corn.

Increased area is not the only factor. It seems that we can expect substantially better yields for the winter wheat crop as well. Yields were very poor in 2006-07, at 38.7 bushel per acre, compared with 42 and 43.2 bushels per acre in 2005-06 and 2004-05, respectively. Although it is very early and there is ample time for weather to interfere, crop conditions are far superior to last year at this time. Consider Table 1, which shows a comparison of the good-to-excellent portion of winter wheat crops for the key producing states.

Table 1 – Good-to-excellent portion of crop

	2006	2007
Arkansas	67%	73
Colorado	46	82
Kansas	26	72
Montana	46	71
Oklahoma	11	67
South Dakota	36	46
Texas	7	58

A conservative estimate based on the average harvest recovery rate of 2004-05 and 2005-2006 of about 86% and a return to 2004-05 yields of 42 bushels per acre would give us a 2007-08 US wheat crop of about 59 million tonnes, up from 2006-07 output of 49.3 million tonnes.

Looking at some other important production regions, we find generally improved crop prospects. Australia completed its worst harvest in modern history, with a paltry 10.5 million tonnes, compared with crops of 25 and 23 million tonnes in the two previous seasons. Australian farmers are just getting ready to plant the 2007-08 crop, which won't be harvested until the end of the year. With weather conditions expected to return to normal, the USDA attaché

provided an early estimate of 22.5 million tonnes.

EU crops are poised for a strong comeback with some analysts talking about achieving record crops. Eastern European crops are also expected to bounce back.

On March 29 the International Grains Council reaffirmed its February 22 estimate for global production of 624 million tonnes, up from 593 million tonnes in 2006-07. We've seen estimates by reputable private forecasters as high as 640 million tonnes.

If there is a bullish case at this time it would involve India. Indian production has been steady, but its population is growing by close to 2% each year. Output is expected to return to 2004-05 levels of 72.5 million tonnes after two sub-par years, when production reached only 69 million tonnes. In 2006-07 India became a net importer of wheat, purchasing 6 million tonnes abroad. Government officials have indicated that the figure may rise to 15 million tonnes this year. In 2002-03, carryover stocks were as high as 20% of consumption, but because of poor crops and increased demand, Indian stocks are currently 5% of usage, a ratio that does not sit well with the public planning community. It may be years until India can become self-sufficient again, and it could become an important player in world trade.

The acreage report sent May wheat tumbling to six-month lows. We would consider establishing short positions on rallies to what we believe is now the major trend.

[March 30, 2007]

Chart 4 – Daily May wheat



Courtesy Reuters

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