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Cotton: getting back to basic fundamentals

Cotton prices have taken a wild ride over the past two months. After breaking out of a multi-month base in mid-February, it took just two weeks for the market to spike 30%, with new-crop December just missing the $1-per-pound mark. The inevitable correction was equally swift and probably had little connection to cotton-related fundamentals.

While we remain bullish on cotton prices, we acknowledge that the sharp runup in such a short period of time was part of the broad blowoff in commodity prices, just as the pullback was part of the bursting of the commodity bubble. Whether the bubble was actually damaged beyond repair is not the subject of this discussion.

The March USDA supply/demand situation report did not do justice to the bullish case.

The most recent weekly export report showed commitments of 460,000 bales. The average of the previous 4 weeks, however, was under 200,000 bales, which prompted the USDA to slash its estimate for US 2007-08 exports by 1.2 million bales, to 14.5 million bales. To meet the pre-revision USDA estimate for annual exports, weekly sales would have had to average much closer to 300,000 bales per week. It is quite possible that the sudden drop in foreign purchases was not so much a result of slack demand as it was a balk at the spike in prices. Now that prices have pulled back somewhat, the buyers may be emerging once again.

That was the only revision of significance. A 500,000-bale drop in the estimate for Chinese output was balanced by a 400,000-bale increase in Pakistani production.

Combined, the revisions will see the estimate for global ending stocks grow to 59.16 million bales, or 48% of consumption, up from the February estimate of 45%, and nowhere close to bull market territory.

A burdensome carryover is hardly bullish, but the 2007-08 season is not the issue. On March 31 the USDA will release its second acreage report for the 2008-09 season. Estimates for cotton plantings are in the range of 9 million to 9.5 million acres. This is down from 10.83 million acres planted in 2007-08, which was already dramatically below 2006-07 planted area of 15.27 million acres.

Assuming the acreage estimate comes in somewhere in the middle of the guesstimate range and further assuming a repeat of last season's record yields of 871 pounds per acre, US output will be down about 15%, or close to 3 million bales.

Even if the steady upward trend in global consumption remains intact and is not affected by the strongly presumed economic slowdown, a 3-million-bale drop in US output in itself will not draw global inventories down to devastating levels. We figure that if little else changed, global 2008-09 ending stocks would be about 44% of consumption.

That is the complacent view. Many questions remain, though. Can US crops achieve optimum yields again? Will the precious few significant exporting countries such as India and Brazil also opt for a switch to more profitable crops?

Chart 2 shows that even after cotton's bull run, its price is still depressed in terms of soybeans, corn, and wheat prices. This leads us to believe that whatever decisions were made over the past few months, they almost certainly favored planting anything but cotton.

We expect the cotton market to outlive the broad commodity bull market. The supply/demand fundamentals are independently bullish and do not require commodity and index fund money to keep the bull alive. Remain long.

[March 28, 2008]

Inside

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

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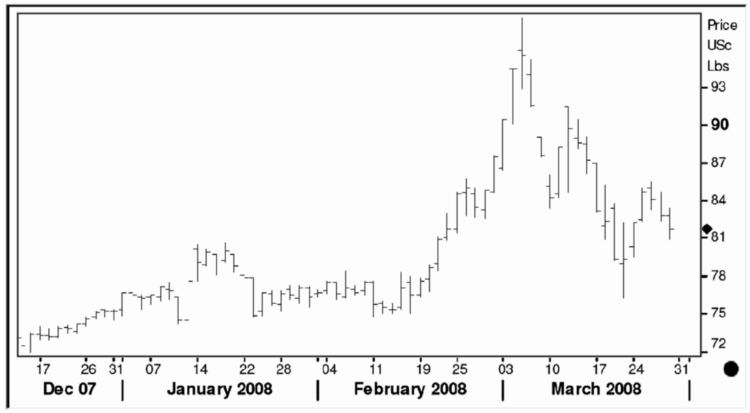
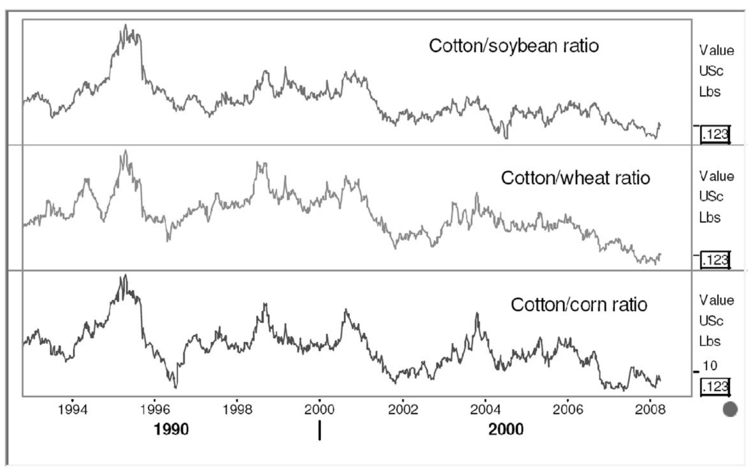
Chart 1 – December cotton



Courtesy Reuters

Chart 2 – Cotton ratios



Courtesy Reuters

COPPER

Recession...what recession?

As evidence of recession mounts, so does the price of copper. Who would have believed that with the current state of the economy, the price of one of the most widely used industrial commodities would be nearing fresh all-time highs? The copper market participated in the March commodity decimation, but did not come close to violating the integrity of the long-term uptrend line, and unlike most other markets, has recouped the bulk of its losses (Chart 3).

On March 27, the International Copper Study Group (ICSG) released its 2007 global summary, which showed that the deficit had eased towards the end of the year. The seasonally adjusted deficit was as high as 124,000 tonnes at the end of August, but finished the year at 42,000 tonnes. Mine output grew 3.2% over 2006, while total supply, which includes scrap recovery, increased 4.5%. Global consumption outpaced supply, growing 6.6% over the previous year. The combination of mine output and scrap recovery kept supply growth at a fairly steady pace all year, even during periods when mine output slacked. Total demand, however, slipped from a growth rate of about 8.5% at mid-year, which explains the smaller deficit.

More current data show that we cannot count on the supply side to balance the market. Chilean output grew 3.8% in 2007. Current estimates are calling for a similar rate of growth in 2008. February output was up 8%, but the pattern has been for big months to be a flash in the pan rather than the beginning of a trend. Back in September, Chilean output was up 21.6%, but output has been down in every month since, until February, that is. Including those two big months, the average monthly production increase was 4%. Thus, the outlook for balancing the market from the supply side is dim.

In the US, the demand side is developing as might be expected. Sectors of the economy that use copper intensively are certainly showing signs of strain. The April 1 reading of the ISM's index of national factory activity was up slightly, but for the second consecutive month, it was in the area economists consider a contraction of the manufacturing base. The March 18 housing data showed housing starts down 0.6% for February, but building permits, which are more of a leading indicator, were down 7.8% for the month.

All of which means that if demand in Asia does not outpace expectations, it will not be long before the market does move back into surplus territory. February was a bit softer for Chinese usage, but the level of imports has by-and-large remained fairly steady, as it has in India.

Warehouse stock activity supports the bull run. Combined inventories at LME, COMEX, and Shanghai warehouses are in a clearly defined downtrend. Last week, stocks sank to a level last seen in December 2006 (Chart 4).

Commodity funds have now switched to the long side, and the commercial short position is quite large in historical terms, which means that the stage is set for a pullback that will challenge the mettle of speculative longs.

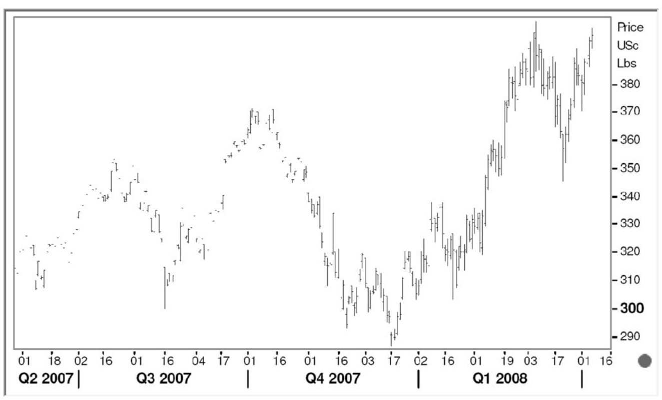
It's been nice to ride the long side, particularly because there is a supportive case with the global market in deficit. Should anyone have been so fortunate as to stay the course with a long position, stops should be raised to $3.40 per pound, basis the nearby contract.

One might, however, consider the possibility that prices will continue to rise – to some degree – because of the broad appetite for owning commodities. For some markets – very likely copper – at least some of the fundamentals are being conveniently ignored.

A potential bearish strategy that may not interfere with rising prices is to sell the backwardation that has developed. The July/December spread (Chart 5) peaked in mid-February, and has not recovered with the market, which is possibly an indication that there is no *bona fide* tightness in this market.

[April 7, 2008]

Chart 3 – May copper



Courtesy Reuters

Chart 4 – Global warehouse stocks

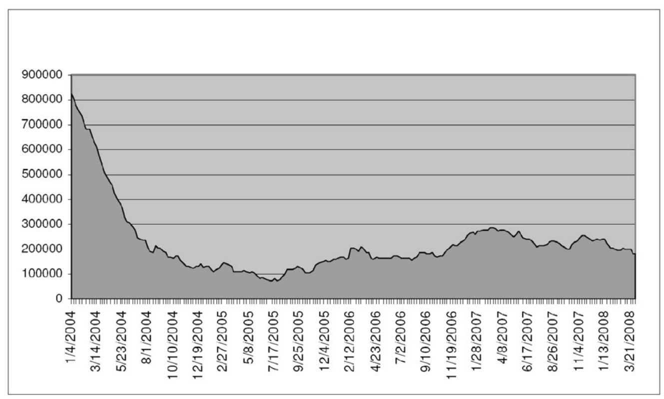


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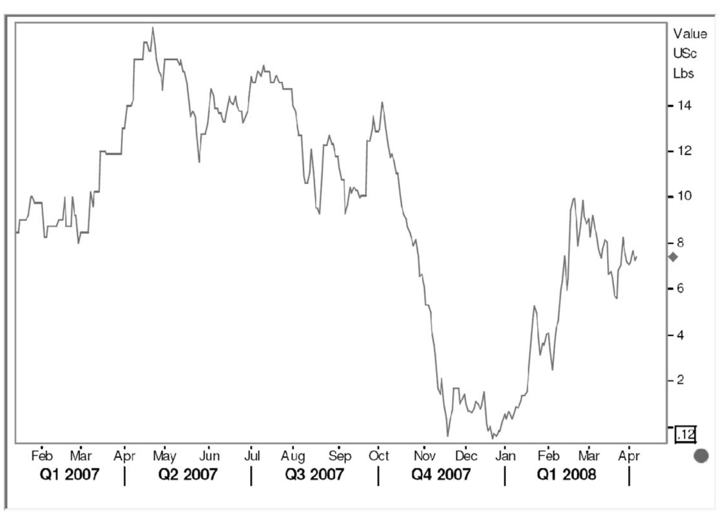
Chart 5 – July/December copper spread



Courtesy Reuters

CORN

Disappointing corn acreage for new-crop

After being early corn bulls, way back when a bushel of corn had a "$3 handle," we gave up too soon, mostly because we believed that estimates for ethanol usage had been overstated. We just didn't see the urgency. There have been many developments, and at present, corn has become king of the commodity pits, having the distinction of being one of the few major commodities to make new highs after the first significant drubbing of the commodity markets (rice and reformulated gasoline are the others).

Soybean prices rose dramatically versus corn throughout 2007 and into this year (Charts 6, 7, and 8), which allowed farmers to lock in truly extraordinary prices for new-crop beans and ensure a large crop – naturally – at the expense of corn acres. As recently as February 22, at the USDA Outlook Forum, 2008-09 corn acres were projected at 90 million acres, down from 2007-08 area of 93.6 million acres. But the March 31 planting intentions report showed corn acres at 86.014 million acres, significantly below the average of analysts' guesstimates of 87.387 million acres.

It is premature to talk about yield per acre at this stage of the season, when plantings are just getting underway, and particularly because it seems that we're going to have a late start because of excessive moisture. But a rough calculation using the 3-year average of the planted-to-harvested-acres ratio and yield means that the US will produce a corn crop of only 11.75 billion bushels.

This is almost laughable considering the kind of predictions we're seeing on ethanol usage. The average estimate for the portion of the 2008-09 US corn crop that will be turned into ethanol is 4.05 billion bushels, up from 3.2 billion bushels in 2007-08. Ethanol would then use up 34.4% of the crop, compared with 24.4% in 2007-08, 20% in 2006-07, and a scant 14.4% in 2005-06. The US farmer has not adequately addressed the ethanol issue. With crude oil seemingly nestling comfortably into the $100-per-barrel zone, ethanol demand can only be expected to grow.

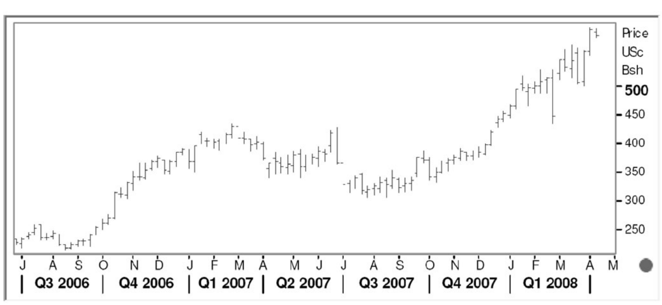
Possibly further complicating matters, and limiting the hope that US farmers will still increase corn acres, is the pop in natural gas prices. For most of 2006 and 2007, natural gas prices were confined to a fairly narrow range (Chart 9). The recent rally, which has seen spot prices literally double over a 7-month period, will push up prices for nitrogen fertilizer, which is used for about 96% of corn acreage in the US, compared with only 20% for soybeans.

With all else being equal in 2008-09, such as domestic feed usage and exports, and of course with cooperation from the weatherman, the addition of close to 1 billion bushels of ethanol consumption could pull US ending stocks down to historic lows, perhaps as low as 400 to 500 million bushels, or a downright scary 3% of consumption. The previous low was 5% of usage at the end of the 1995-96 season, which saw corn prices shoot to $5.50 per bushel.

The only other producers that can contribute a reasonable amount of corn to world trade are Argentina and Brazil. Their 2007-08 crops are currently being harvested and will be about the same size as last year. Even if they both crank up output for the coming season – as they have done with soybeans over the past 5 years when it became obvious that the US could not meet the world's needs alone – supplies would not be available until next spring.

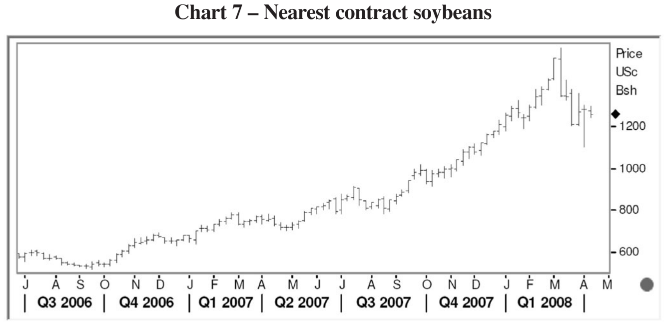
Better late than never. Buy new-crop December corn. Place initial stops at $5.40, close only. *[April 8, 2008]*

Chart 6 – Nearest contract corn



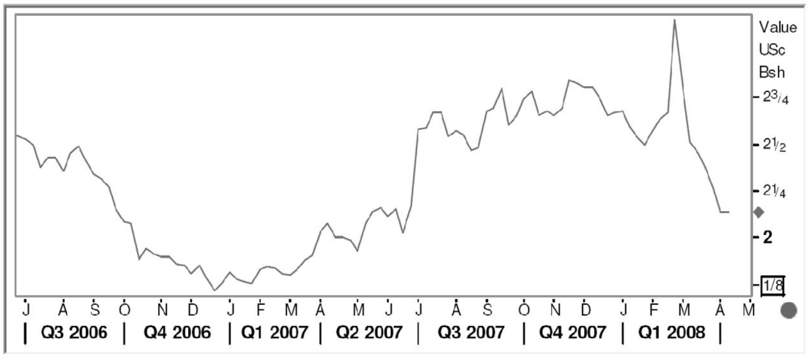
Courtesy Reuters

Chart 7 – Nearest contract soybeans



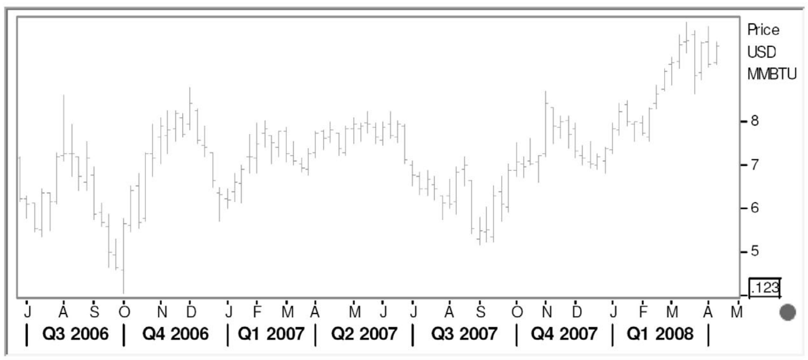
Courtesy Reuters

Chart 8 – Soybean/corn ratio



Courtesy Reuters

Chart 9 – Nearest contract natural gas



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SUGAR

Surplus? Not for long

We begin this discussion of the sugar market with something of a continuation of this month's article on corn.

The massive campaign by governments worldwide to lessen dependence on fossil fuels by diverting usage of crops, such as sugar, corn, and soybeans, that have traditionally been used solely for human or animal consumption to produce biofuels, is making inroads. Indeed, to such an extent, that we have come full circle, and we are – at least in the case of corn – creating potential shortages of the very feedstocks that are being used to make biofuels. (See *Focus on Futures*, April 8, "Disappointing corn acreage for new-crop.")

In the February 12 issue of *Focus on Futures* we speculated that "A rather futuristic wild card, which has been the subject of discussion in the rumor mills, is the possibility of a new Administration reducing or even eliminating the 50% tariff that the US charges on ethanol imports from Brazil." The tariff expires at the end of this year, and while the odds of any US government messing with its fortunes in farm states are small, the topic is certainly no longer futuristic.

On April 4, Tom Shannon, the Assistant Secretary of State for Western Hemisphere Affairs said, "If our goal is to reduce hydrocarbon usage and to increase ethanol usage, that is going to happen through cane-based production…Even with all the production happening in the United States, we won't be able to fill our demands, so it's going to require the importation of biofuels."

A far more influential government official has addressed the issue in a far more direct manner. On February 28, in testimony to the Senate Banking Committee, Federal Reserve Chairman Ben Bernanke said, "As you know, I favor open trade and I think allowing Brazilian ethanol, for example, would reduce costs in the United States."

As it is, the ethanol and sugar markets in Brazil are jockeying for position for a fair share of the cane crop. It is estimated that a record 56% of the cane crop currently being harvested will be crushed into ethanol. All of the ethanol that will be produced will be consumed domestically or exported. If a channel were created for export to the US, i.e., a modification of the present tariff system, sugar production would be squeezed even further.

We're not predicting that any of this will happen in the foreseeable future, but any degree of repeal of the tariff would have an impact on Brazilian sugar supplies. We should also bear in mind that some Brazilian ethanol already slips into the US tariff-free through third-party countries that are not bound by import or export restrictions. If that method remains profitable, it will grow and put some strain on the Brazilian ethanol/sugar ratio.

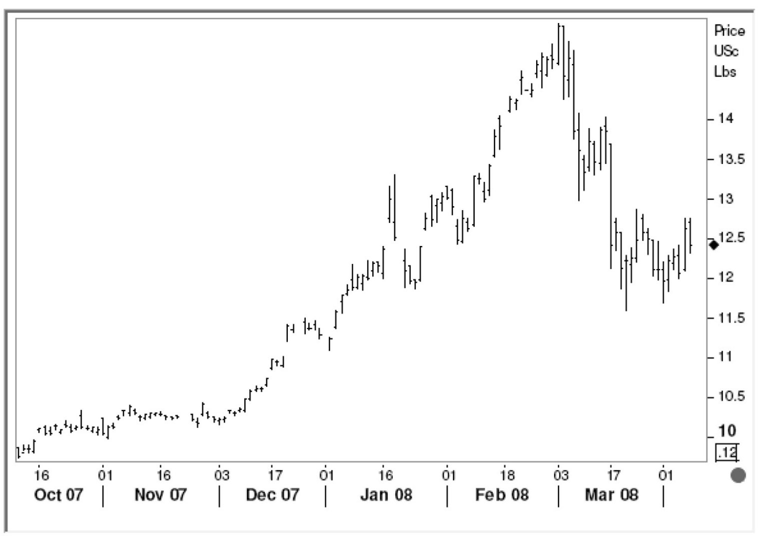
All the major sugar analysts continue to forecast about a 10-million-tonne global surplus for 2007-08. They've all come down a bit, but we're not certain how they all account for the fact that everybody believed that India was going to produce 32 to 33 million tonnes of sugar this year, but ended up with output of only 28 million tonnes. In any case, planted area for the new 2008-09 Indian crop is 20% smaller, and early estimates are calling for a 24-million-tonne crop. Domestic consumption is about 20 million tonnes, and we believe that most of that excess will go towards rebuilding inventories. Exports this marketing year will probably reach 3.5 to 4 million tonnes, according to most analysts, but it is unlikely that India will play any significant role in world trade in the 2008-09 season.

Another interesting issue that is likely to become an important feature in the sugar market, but that has not received much attention, is the cost of production in Brazil. Brazil has always benefitted from being the world's most cost-efficient grower and crusher of sugar. As aging mills are rebuilt or modernized, those costs have risen. We've seen a wide range of estimates – the average is about 12¢ per pound. With prices hovering at 12¢ per pound, the incentive is not exciting.

We are quite confident that 2007-08 surplus estimates will shrivel over the coming months. We're certain that with the drop in Indian output, and with ethanol likely to grab an ever-increasing market share of the Brazilian cane crop, the 2008-09 marketing year will be at best balanced, but highly vulnerable to slipping into deficit.

Maintain long positions. *[April 8, 2008]*

Chart 10 – July sugar



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