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Cocoa: Ivorian recovery shrivels

You wouldn't know it from recent price action, but the major fundamental factors that influence the cocoa market have actually become supportive for prices.

Production estimates for up-and-coming producing nation Cameroon have been inching up. Output is now expected to top last season's record 205,000 tonnes. Brazil is expected to harvest an optimum-sized mid-crop. The amount of additional cocoa involved is insignificant in the grand scheme, though, and that's where the bearish supply-side news ends. None of the other large producers are having great crop years.

Indonesian output estimates can be as volatile as cocoa prices, but a recent ICCO estimate, which is as reliable as it gets, puts production at 500,000 tonnes, slightly above 2008-09. That's down from earlier estimates that put the crop as high as 600,000 tonnes, and never mind the government's 1-million-tonne estimate.

Ghanian arrivals stand at 501,000 tonnes, down 4.3% from last season at this time. The target for 2009-10 is about 700,000 tonnes, down slightly from last year, but arrivals would have to pick up to meet the forecast. For years, authorities have been talking about expanding production to 1 million tonnes by the end of the decade. The crops have generally been getting larger – at least until this year – but the rather optimistic forecast for a near 50% increase in output has been moved forward to 2012. Actual production is probably higher than indicated by arrivals, because a significant amount of beans are traditionally smuggled to neighboring Ivory Coast, where prices paid to farmers are higher.

Details of Nigerian cocoa output are sketchy, but from what little information does exist, it seems that its output this season was flat as well – about 325,000 tonnes.

The most important issue, of course, is the disappointing outlook for the Ivorian crop. As the main crop draws to a close, the pace of arrivals has dwindled. As of March 22, arrivals stand at 873,000 tonnes, just 4,000 tonnes, or less than 1%, above last year at this time. Weekly arrivals are running at about one third of last year's pace, which means that within a week or two we will actually be behind last year's output level – and that was not in the script.

The International Cocoa Organization (ICCO) is forecasting a better-than-expected Ivorian mid-crop of over 300,000 tonnes. This is certainly attainable, but that still puts the total of the main- and mid-crops at about 1.2 million

tonnes, no larger than last year.

So global production for 2009-10 will, at best, be flat. Sluggish demand has countered any concerns that may normally have emerged. Grinders have held back bean purchases, balking at paying up for beans when processing margins are so weak. Information on butter supplies is scarce, but talk is that inventories have dropped down to dangerously low levels as a result of grinder reluctance to operate with slim profits.

Last month, butter ratios fell to their lowest levels since 2002 (Charts 2 and 3) but then bounced sharply. This was evidence, perhaps, that butter supplies are indeed very low, and a wave of buying has emerged.

The ICCO estimates that the global market will finish with a small deficit of 18,000 tonnes for 2009-10 and move into a surplus position in 2010-11. The basic assumptions are that high prices will encourage output growth of 5%, but demand will remain weak, growing by only 2.5%.

For the most part, prices have been well above the historic norm since 2007, and while farmers and their governments may have been inspired to plant more and optimize fertilization, there has been little evidence – particularly in the Ivory Coast – that such a process is underway. On the other hand, the global recession has cut into demand, but that will not last indefinitely. We expect grinding activity to improve in the coming months.

Maintain modest long positions. [March 23, 2010]

Inside

Copper: Assessing damage	2
Corn: Ample supply, sluggish demand	4
Cotton: Sticker shock	5

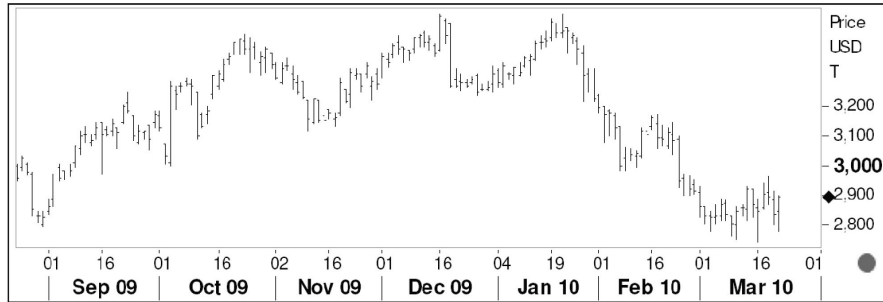
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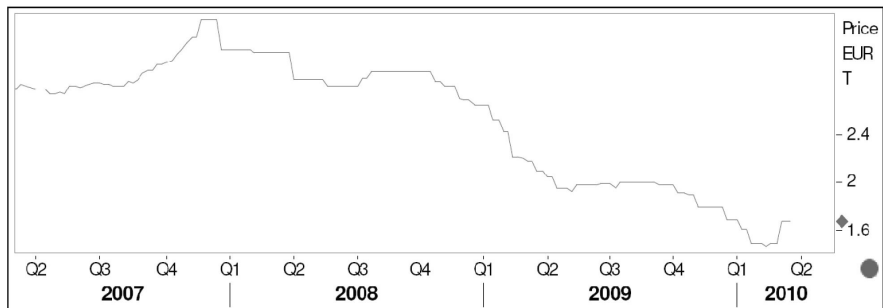
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Chart 1 – May cocoa



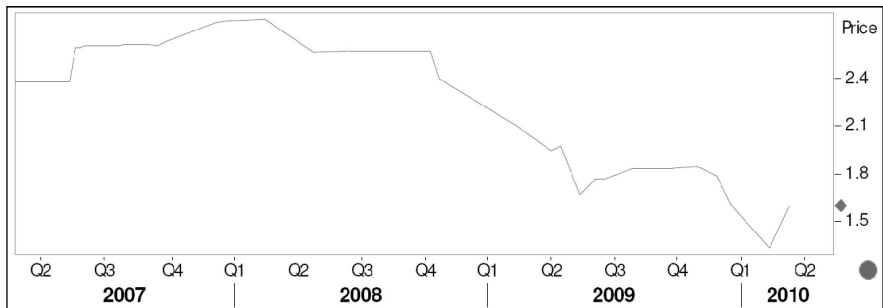
Courtesy Reuters

Chart 2 – European butter ratio



Courtesy Reuters

Chart 3 – Asian butter ratio



Courtesy Reuters

COPPER

Assessing the damage

On February 27 Chile was rocked by a powerful earthquake measuring 8.8 on the Richter scale. Hundreds of Chileans lost their lives, and many thousands were left homeless – a tragic event.

There was concern over the economic fallout, and in particular regarding the effect on copper production. Copper mining and exports are an integral part of the Chilean economy. Copper is Chile's largest export. Its mines produce roughly 35% of the world's annual copper output.

Within hours of the quake, a series of strong aftershocks

added to the tension and left commodity and equity traders nervous about damage to mines, refining facilities, and energy infrastructure, which are vital for keeping the many large and small mines in production.

The earthquake struck on a Saturday, so there were no markets open anywhere around the globe. Shortly after the Sunday 6:00 p.m. open on GLOBEX, May copper spiked to \$3.48 per pound, 20¢ above the previous Friday's close. Almost four weeks have passed without the market surpassing the high set on that tension-filled Sunday evening (Chart 4).

Some mines were shut temporarily, but the amount of lost production was minimal. The epicenter of the quake was in the southern part of the country, about 300 kilometers south of Santiago. Over 70% of the country's mining activity is located in the northern part of the country near the Peruvian border, which sustained no damage and operates on a separate power grid. The mines in the South were more susceptible to shutdowns, because energy delivery remained vulnerable. Indeed, on March 15, the damaged power grid triggered a blackout that resulted in temporary production halts in some mines in the South, but again, the large mines in the North were unaffected.

No question that some output was lost. Monthly mine output figures for Chile are released at the end of each month for the previous month. This month's report will cover output only through the end of February.

In the interim, on March 22 the International Copper Study Group released its final balance sheet for 2009, which showed a global refined copper surplus of 365,000 tonnes, up from a 224,000-tonne surplus at the end of 2008. Mine production grew by 2.65%, and consumption was flat. The most recent data from the World Bureau of Metal Statistics show that 2009 began with an 87,000-tonne surplus for January.

There have been a couple of bullish developments.

Chinese imports for February were higher than expected (Chart 5), and global warehouse stocks downticked for the first time in close to a year (Chart 6).

The balance of evidence, however, remains overwhelmingly bearish. Cost of production is light years below the market price, and while mines exercised restraint to cut back production during the global economic recession, they are cranking up output again. Consumption is sure to improve with stabilizing economies, but with a surplus and robust production levels, it is almost inconceivable that the market can experience any tightness.

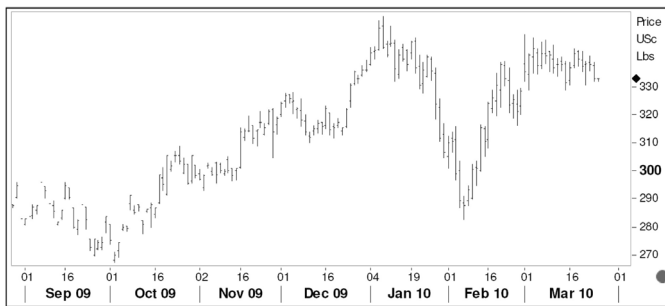
Ironically, the devastating Chilean earthquake may have revealed the true colors of this market. Without keen interest for the long side from commodity funds, this market can go nowhere but down. The market was unable to establish a fresh recovery high, even in the aftermath of one third of the world's mine supply being threatened. Chart 7 shows that the commodity net-long position on COMEX peaked late last year.

Even more intriguing, Chart 8 shows that the stock market has sprinted to fresh recovery highs leaving copper prices in the dust. Technically speaking, it's a powerful non-confirmation of the traditional relationship copper has shared with the stock market.

Remain short.

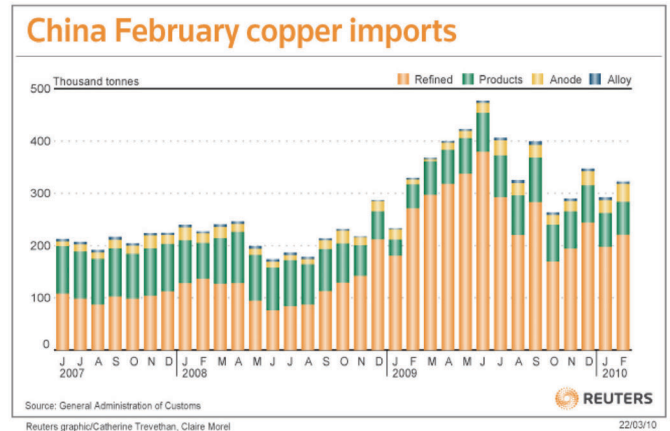
[March 25, 2010]

Chart 4 – May copper



Courtesy Reuters

Chart 5 – Chinese copper imports



Courtesy Reuters

Chart 6 – Global copper warehouse stocks

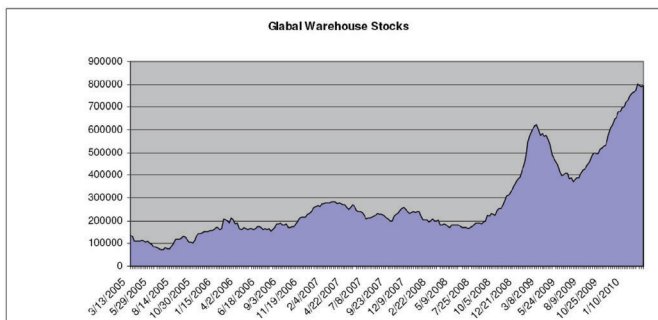
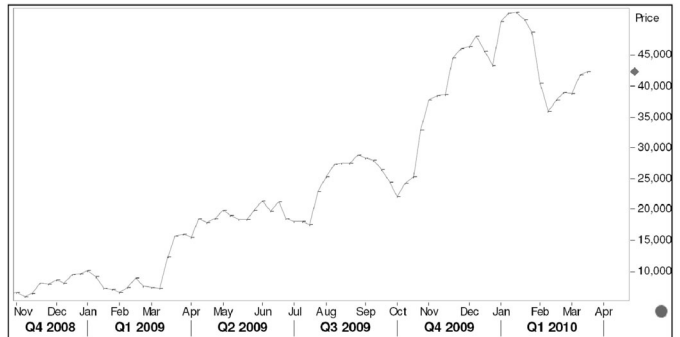
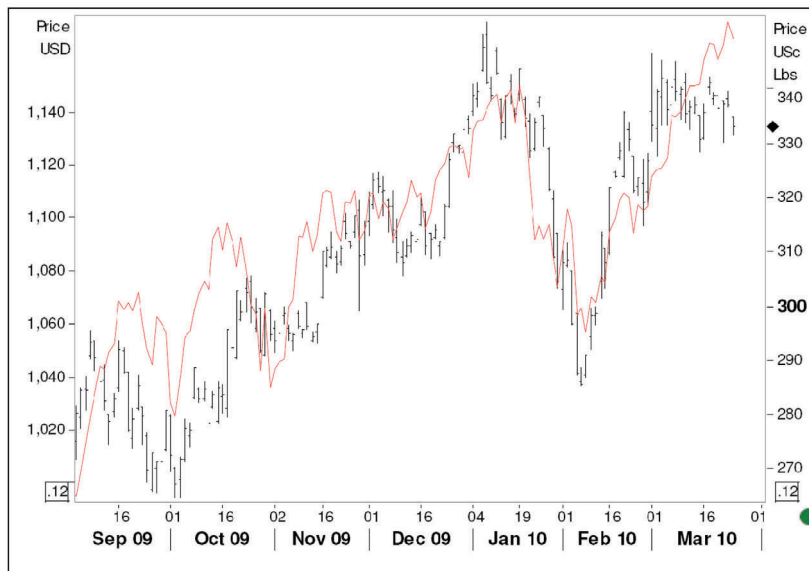


Chart 7 – Commodity fund net-long position on COMEX



Courtesy Reuters

Chart 8 – Daily copper (bar), S&P 500 Index (line)



Courtesy Reuters

CORN

Ample supplies and sluggish demand

Corn prices peaked in January when the USDA threw traders a curve ball by revising the estimate for the 2009-10 US crop upwards by 230 million bushels, to 13.151 million bushels. The market had been trading off an expectation for a *downward* revision of more than 100 million bushels. May corn has since tumbled by 80¢ per bushel (Chart 9).

In the January 29 issue of *Focus on Futures* we observed that global inventories have not been rebuilt to pre-bull-market levels, but concluded that as long as demand remains sluggish, prices will remain range-bound.

For the most part, supply/demand developments have been to the bear side.

Estimates for the 2009-10 Argentinean crop – currently in harvest – were as low as 15 million tonnes, as recently as January. Early-season drought threatened a second consecutive crop failure. Timely precipitation, however, saved the crop. In its March crop report, the USDA raised the estimate to 21 million tonnes. Over the past month there have been bouts of excessive rains, which would have hampered harvest activity, but weather conditions are now ideal for both late filling corn and harvest. A labor dispute among port workers has been cited as an explanation for rallies. Like all labor disputes, however, it will be settled, and does not change the fact that several million tonnes of corn that the market believed did not exist one month ago will soon be available for export.

The USDA's estimate for Brazil is 51 million tonnes, but private forecasters have higher forecasts. Informa Economics puts the crop at 53.3 million tonnes.

With economies around the globe stabilizing, a certain degree of demand recovery has been built into consumption forecasts for many commodities. On that front corn has been a major disappointment. At the beginning of the marketing year in September, the USDA forecast exports at 55.88 million tonnes, far from record foreign sales that reached 61.91 million tonnes in 2007-08, but a robust improvement over 2008-09 sales of just 47.18 million tonnes.

In early February commitments were 17% out in front of the same time the previous season, which was right in line with the US forecast for annual exports. Sales have been slipping, though, and that forecast has been revised down every month since. Commitments are now only 6% ahead of last year at this time. In response, the March USDA estimate was revised down by 2.54 million tonnes from the February figure, to 48.26 million tonnes.

Average weekly sales have been 800,000 tonnes, 760,000 tonnes, and 613,000 tonnes in January, February, and March, respectively. With 23 weeks left to the marketing year, weekly commitments would have to average 633,000 tonnes to meet the USDA target. That's a tall order, but possible if business picks up.

The next issue that traders will focus on is the 2010-11 US crop. The February USDA Outlook Forum estimate for planted acres was 89 million acres, substantially higher than 2009-10 acreage of 86.5 million acres. Private estimates range from 88.4 million to 90.15 million acres. Last year wet fields in the spring resulted in late planting and remained a factor all season long. On the whole, planting conditions at

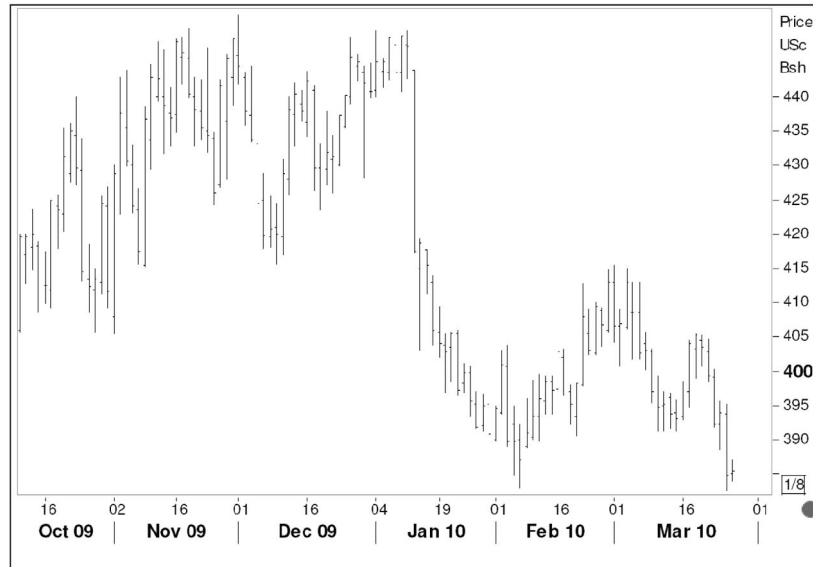
present are favorable.

It seems that regardless of the challenges the crops deal with, in terms of delayed planting or growing weather, yields keep getting bigger with improved technology. In the March crop report, the USDA revised the 2009-10 yield down a tad to 164.9 bushels per acre (bpa), but it was still a record, up

from 153.9 bpa in 2008-09 and 150.7 bpa, in 2007-08.

Establish short positions in December corn on any rally. Place initial stops at \$4.20 per bushel, which is above the recent highs and which would likely be the result of improved demand or a weather problem or a combination thereof. *[March 29, 2010]*

Chart 9 – December corn



Courtesy Reuters

COTTON

High prices bring larger crops and sticker shock

After rallying to two-year highs in February, cotton prices have consolidated their gains (Chart 10). The market has paused in anticipation of the March 31 planting intentions report. Preliminary forecasts are calling for a sharp increase for cotton acreage. In February, the USDA estimated 2010-11 acreage at 10.5 million acres, up from 9.15 million acres in 2009-10 and 9.47 million acres in 2008-09. Farmers planted less cotton the past two seasons because corn, wheat, and soybean planting was far more profitable and because demand was expected to be weak during the global recession.

Demand recovered sooner than anticipated, however, and as a result, cotton has remained one of the stronger commodities on the board.

The 2009-10 Chinese crop suffered from poor weather and is much smaller than the previous year's. In its March crop report, the USDA lowered its output estimate by 500,000 bales, to 31.50 million bales. That's much lower than 2008-09 output of 36.7 million bales. And the USDA has been slow in lowering estimates for Chinese production. Some analysts put production as low as 29 million bales.

Estimates for Chinese demand, on the other hand, have been stronger than anticipated. The March estimate is 47.5 million bales, about 1.25 million bales above early season estimates and 3 million bales higher than 2008-09 usage.

Thus far, Chinese purchases of US cotton in the 2009-10 marketing year are actually running behind last year's pace, but that hasn't stopped US exports from putting in a surprisingly strong performance, with buying coming from other customers.

The most recent commitment data show that we are 11.6% behind last year's pace. In early January, sales were 21% behind. The USDA has been steadily pushing up the estimate for annual exports. At the beginning of the marketing year in August, when the global economic outlook was strictly gloomy, the forecast for 2009-10 US exports was 10.2 million bales. That would have been the lowest tally in 10 years, about the time of the monumental shift of US cotton usage to exports from domestic mill consumption. But with periods of excellent sales, the USDA has raised its forecast to 12 million bales.

During January and February, old-crop weekly sales were extraordinary, with some weeks showing well-above-average

numbers, but over the past few weeks that torrid pace of sales has calmed down. To meet the USDA target, we would need weekly sales to average about 135,00 bales, which is right about what we've seen since the beginning of March.

With Chinese output numbers falling and consumption numbers rising, the estimate for 2009-10 global ending stocks now stands at the lowest level since the mid-1990s. The March estimate fell to 44.4% of consumption, down from 56.7% in 2008-09 and 51% in 2007-08.

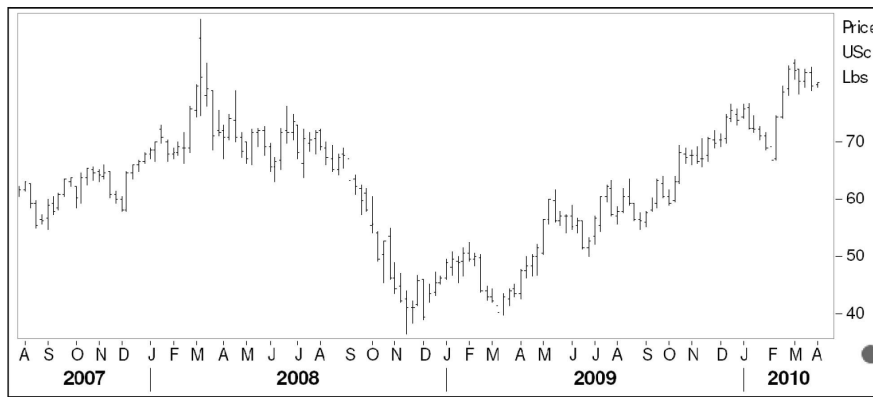
In conclusion, the fundamentals are bullish, as illustrated, but vulnerable. If the March 31 US acreage estimate is in line with expectations, it will be greeted with a yawn.

Over the past year, cotton prices have been rising *vis-à-vis* the prices of competing crops, such as soybeans, as illustrated by Chart 11. So a jump in cotton acreage is a given. However, a much larger-than-expected increase would spark a selloff.

The 2010-11 Chinese crop is not harvested for many months. The relatively light level of Chinese participation in importing US cotton is a bit puzzling. It is not inconceivable that high world prices have inspired a drawdown of reportedly large inventories, at least until prices come off.

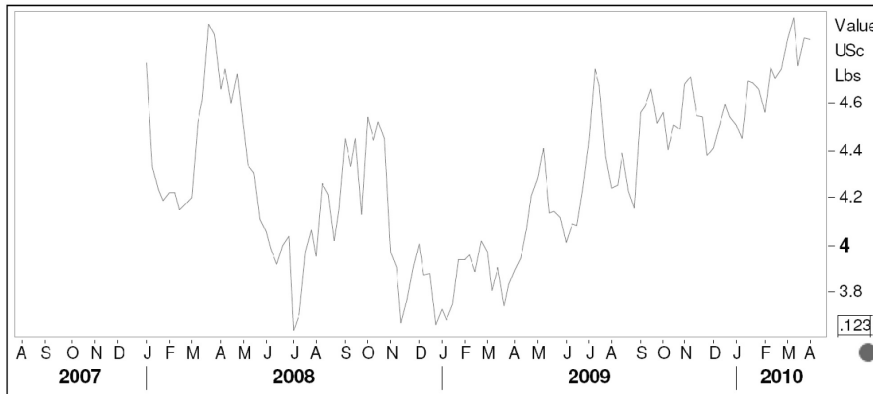
Remain long, but raise sell stops to 7700, basis May, close only. [March 29, 2010]

Chart 10 – Weekly nearest contract cotton



Courtesy Reuters

Chart 11 – New crop cotton/soybean ratio



Courtesy Reuters

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