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Is the copper bull showing signs of strain?

The bull run in copper prices has been struggling. Some evidence that the recovery in the US economy has been sputtering has surfaced. Primarily, the most recent non-farm payroll data showed that only 120,000 jobs were created in March – considerably below expectations and the lowest monthly level since last October. Copper prices are generally seen as a reliable leading indicator of economic health. So it was somewhat worrisome that after outperforming stocks for most of the period after the 2008 bottom, copper prices topped out vis à vis stocks early in 2011 (Chart 1).

The impact of any single region is dwarfed by the effect of demand out of China, where usage accounts for roughly 40% of global consumption. Chinese economic data are scrutinized for any indication that commodity imports will suffer. The general consensus is that China has avoided a hard landing. GDP figures released on April 12 showed that the economy grew by 8.1% in the first quarter (annualized), below analysts' expectations for 8.4% growth. That compares with 8.9% growth recorded in the fourth quarter of 2011 and 9.7% in the first quarter last year.

The HSBC/Markit Flash Manufacturing Purchasing Managers Index for China, released on April 23, rose to 49.1, up from 48.7 in March. Still, it remained below the critical 50 level, which marks the threshold between contraction and expansion in the sector, and indicates strains in China's economy, as exports shrink while domestic demand remains stagnant.

The International Copper Study Group's (ICSG) most recent data show that 2011 ended with a 358,000-tonne deficit. Consumption/production developments over the past few months have not shown dramatic changes, so the global balance sheet is probably still in deficit.

Figures released on April 10 show that Chinese month-over-month imports for March were down 4.65%. However, as we can see in Chart 2, it's hard to view the overall picture as terribly bearish. February imports were the second highest on record, and even January – the weakest month for imports so far this year – was substantially above year-over-year levels.

On the supply side, Chilean production is as much a swing factor for the global market as is consumption in China. Early forecasts for 2012 are calling for a jump in output of between 6% and 10%. But we've heard that before. A year ago, forecasts for Chilean production called for a 3% increase. Instead, we saw a decline of 3.2%. Early results for this year do not support the predicted surge in output, with January down 7.6%, year-over-year, and February up 6.5%. Weather problems were a significant factor and, naturally, are always a wild card. However, the other two issues, labor unrest and declining ore grades, continue to be obstacles.

Shanghai warehouse stocks have more than doubled since the beginning of the year. However, when inventories are viewed in global terms, they have actually been declining. Chart 3 shows that the combination of LME, COMEX, and Shanghai warehouse stocks has been falling. As always, warehouse stocks remain an inconclusive indicator.

The other base metals traded on the LME, including aluminum, nickel, zinc, and tin – with the exception of lead – have also been sinking to multi-month lows, providing some confirmation that the contributing factors of a questionable recovery in the US and the faltering economies in Europe are affecting demand for industrial commodities.

On March 7 our recommendation to raise the stop on our long position to $3.65 per pound, basis May, was trig-

Inside

Cotton: China dominates 2
Wheat: FSU trouble 4
Cocoa: Why high? 5

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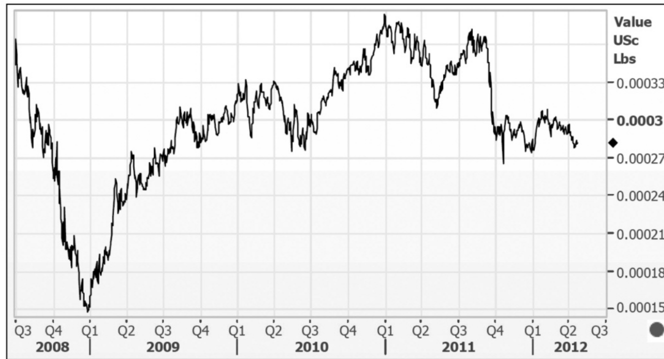
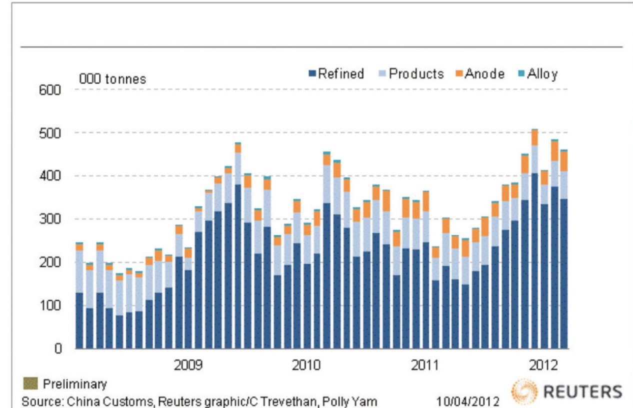
gered. Although there is no clarity regarding the two principal fundamental issues that drive this market – Chinese usage and Chilean output – the tape seems to be telling us that this market could be headed lower. A foray back into the price range in which copper has spent most of 2012, however, would make us nervous shorts. Sell short July copper, but use a rather conservative stop of $3.75 per pound, close only. *[April 24, 2012]*

Chart 1 – Copper/Dow Jones Industrial Average ratio



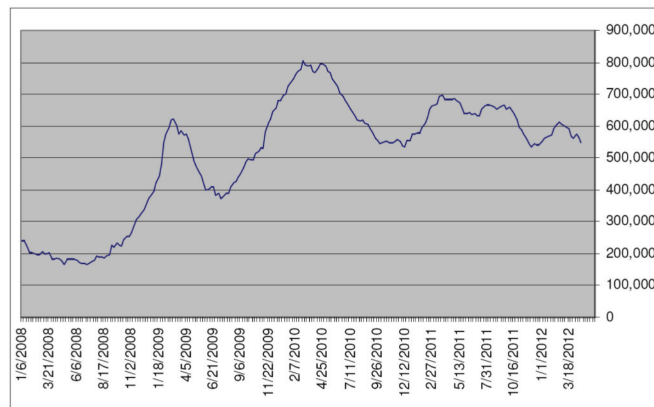
Courtesy Reuters

Chart 2 – Chinese copper imports



Courtesy Reuters

Chart 3 – Global warehouse stocks



COTTON

Chinese imports dominate

Cotton prices have been moving mostly sideways since February (Chart 4). The spread between old and new crop months has been typically volatile (Chart 5). The market is groping for direction.

On the one hand it is tempting to treat cotton like a bear market. With a looming recession in most of Europe and a waning recovery in the US, making a bullish case for an industrial commodity is a challenge. China, however, has been an active importer, shoring up its reserves. The April USDA crop report raised the estimate for 2011-12 Chinese imports by 2 million bales from the March estimate, to 20.5 million bales. That's up from 12 million bales in the 2010-11 marketing year.

The estimate for US exports was raised in the crop report, by 400,000 bales, to 11.4 million bales. Old-crop sales have been dwindling, and we've even seen some light cancellations. The light volume, however, was mitigated by the most recent weekly export report, which showed 144,000 bales of commitments, most of which went to China. With three months remaining in the 2011-12 marketing year we need to average only about 25,000 bales of new sales per week to meet the USDA target. Over the past four weeks, shipments averaged 281,000 bales, which is in line with the 240,000 bales per week necessary to meet the target.

The decent showing of US exports is impressive, particularly in light of the fact that India has exported 20% to 25% more cotton than in a typical year. The Indian government has

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been weaving in and out of an export ban, but either way, the mere fact that there are customers eager to buy is an indication that demand is robust.

After accounting for the revisions contained in the April crop report, the balance sheet indeed presents a very bearish picture. The estimate for global ending stocks was increased by close to 4 million bales, to 66.07 million bales, or a staggering 61.32% of usage, up from the March estimate of 57.32%. That compares with an average carryover of 50.5% of consumption over the past decade.

A significant part of the increase in the forecast for global ending stocks was a 3-million-bale jump in the estimate for Chinese ending stocks and a 1-million-bale drop in the estimate for Chinese domestic mill consumption. All of which means that although Chinese imports have increased dramatically, it doesn't necessarily mean that actual usage is up. However, as one well-regarded analyst pointed out, the cotton that China purchased is not mobile. It was acquired to bolster reserves, and it will either be used by mills or it will just sit there. Either way, it is not available for world trade. The burdensome inventory level portrayed in the official balance sheets are somewhat of misnomer.

The spurt of Chinese stockpiling will come to a halt eventually – when the central planners reach their goal. Looking past that day, we still find that the outlook is not quite that bearish. In planning for 2012-13 crops, we find that farmers are assuming that there will be little growth in overall consumption.

The March 30 planting intentions report showed that US farmers will plant 13.155 million acres to cotton, below last year's 14.73 million acres. It was still deemed a bearish report, because the figure was well above average guesstimates of 12.75 million acres.

We believe, however, that cotton area is subject to downward revisions. New-crop soybean prices have outperformed new-crop cotton prices by a wide margin, and it is clearly more profitable to plant soybeans (Chart 6). Wherever possible, the switch from cotton to soybeans will be made.

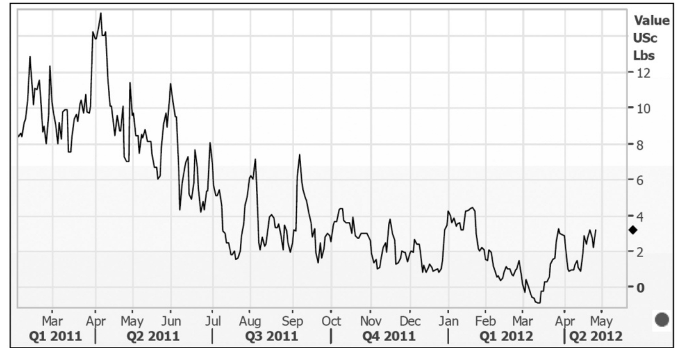
The world's top two cotton producers, China and India, account for close to 50% of global output. Cotton area for the 2012-13 crop in both countries is expected to drop by 10% from 2011-12. If global demand swings back, the market will be extremely vulnerable. Anything less than perfect weather for the new crops will tighten the market.

We have exhausted the downside of this market. Cover short positions in December cotton and establish long positions. Place initial protective sell stops at 84.5¢ per pound, close only. *[April 27, 2012]*

Chart 4 – July cotton

Courtesy Reuters

Chart 5 – July/December cotton spread



Courtesy Reuters

Chart 6 – New crop soybean/cotton ratio

Courtesy Reuters

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WHEAT

FSU winter wheat crops in trouble

Wheat prices peaked nearly a year ago, but have been moving sideways since late last year. The market's focus has shifted from worrying about Southern Hemisphere weather to Northern Hemisphere winter wheat crops.

The USDA April estimate for 2011-12 Argentinean output was 14.5 million tonnes, down from 16.1 million tonnes in 2010-11. Exports are expected to remain steady, though, at 9.5 million tonnes, the same as the previous marketing year.

Australia will harvest a record crop of 29.5 million tonnes, with exports jumping by 3 million tonnes, to 21.5 million tonnes.

After trading down to fresh multi-month lows two weeks ago, old- and new-crop futures contracts bounced back into a well-established trading range (Chart 7). The supply side of the market will be determined by the success of Northern Hemisphere winter-wheat crops.

The March 30 acreage report showed that US farmers increased total wheat area for the 2012-13 crop (winter wheat that was planted last fall plus spring wheat that is currently being planted) by 2.7% over 2011-12. At 55.91 million acres, however, the forecast was substantially below analysts' guesstimates of 57.42 million acres. Wheat prices rallied 45¢ per bushel on that news, but there was no follow through. The market proceeded to make new lows, as noted above.

A possible explanation is that while the planted acreage was a disappointment, the general outlook for the size of the crop has been mitigated by the potential for above-average yields. The most recent USDA crop progress report shows that the good-to-excellent portion of the winter wheat crop stands at 63%, compared with a dismal 35% at this time last year. This is not quite as good as, but roughly in line with, the condition of the 2010-2011 crop at this time two years ago, when final average national yields were a well-above-average 46.3 bushels per acre (bpa). Last year, yields were 43.7 bpa. The average yield for crop years 2005-06 through 2009-10 was 43 bpa.

The progress reports are a bit dated, and more recently, weather has become somewhat of an issue, spurring some buying. Hot weather in the Southwest hard red winter wheat areas and a forecast for potential frost in the Eastern Midwest soft red winter wheat regions have captured the attention of wheat traders.

Of much greater concern, though, is the situation in the FSU. Inclement weather during the planting and growing seasons in Russia, the Ukraine, and Kazakhstan will slash output for the maturing 2012-13 winter wheat crops, particularly in the Ukraine. Russian officials still maintain that output will not decline materially, but that is questionable.

In the Ukraine, however, estimates have been reduced drastically. Official forecasts have not been released, but private analysts say that yield could be as low as 1.5 to 1.8 tonnes per hectare, down from 3.35 tonnes per hectare in 2011-12. Production could fall to between 11 and 14 million tonnes, down from 22.3 million tonnes in 2011-12. Domestic consumption has been between 12 and 13 million tonnes over the past few years. Maintaining exports at even the lowest level of the past few years would mean depleting all its carryover stocks.

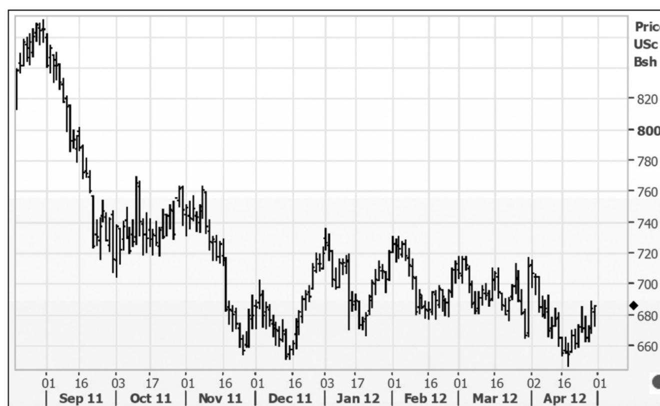
The Ukraine issued export quotas in response to the crop failure in 2010-11, and it's a sure bet that if the crop doesn't improve, it will act again to ensure adequate supplies for the domestic market. The government has already stated that export quotas are not expected, but that is not realistic.

Kazakhstan is also a major export player, and its crop is estimated to fall to 15 million tonnes, down from 22.7 million tonnes last season. Although this does not pose quite the disaster for the export market as does the Ukraine, because domestic consumption is lower, it will still contribute to a lower pool of available supplies for world trade.

The US crop is obviously important, but the US is no longer the supplier of last resort. Aside from the drought-affected 2010-11 season, FSU exports have been roughly 35% larger than US exports since the 2008-09 season.

We believe there is an excellent, low-risk buying opportunity. Buy new crop December wheat. Place initial stops at $6.40 per bushel, close only. *[April 30, 2012]*

Chart 7 – December wheat



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COCOA

What's supporting prices?

By all rights, cocoa prices should be following the path of some of the other soft commodities that are making fresh multi-month lows. Coffee, sugar, and FCOJ are all in precipitous downtrends.

The most widely watched supply-side fundamental, Ivory Coast arrivals, has disappointed bulls. Earlier in the 2011-12 marketing year, forecasts called for lower production because of dry weather for most of the main-crop harvest season, from November through March. As recently as late March, arrivals were still running behind last season's levels. However, precipitation levels normalized during March, and arrivals now stand at 1.081 million tonnes, 37,000 tonnes above arrivals at this time last year of 1.044 million tonnes.

On the demand side, grinding activity has been on the slow side. Most notably, the North American first-quarter grind figures released on April 19, were dismal, falling by 4.04% over the same period in 2011. Not that analysts were anticipating strong results – the median guesstimate was -1.5% – but the number came in near the low end of the range of expectations.

The European grind released a week earlier was unchanged from the first quarter of 2011, in line with forecasts. The only bright spot was the first-quarter Asian grind, which grew by 5.7% year-over-year. These figures include grinding activity in Malaysia, Indonesia, and Singapore. All in all, the data showed that demand was not growing.

And it is of little surprise that grinding activity is so weak. As we've documented over the past several issues of *Focus on Futures*, even while butter prices were falling, powder prices were rising. This provided processors with incentive to buy beans and grind them profitably, even while butter demand was faltering. Over the past few months, however, powder prices began to slide as well, to date falling by close to 20%. Chart 8 shows a decidedly bearish pattern for the combined butter/powder ratio.

So why have cocoa prices held? The early-April sell-off failed to penetrate the January lows, and the market has now built what we consider – in technical analysis speak – a four-month-old base (Chart 9).

Well, for starters, although the data are a bit stale, most analysts have been forecasting that the global balance sheet for 2011-12 will end in a deficit in the neighborhood of 100,000 tonnes. Recent developments, such as those cited above – an improved Ivorian production outlook and sluggish demand – will, at best, bring the market into balance or to a small surplus, but certainly not to a burdensome surplus.

We believe that there is a distinct possibility that cocoa prices have held because of Ghana. In the 2010-11 season Ghanaian output reportedly soared to 1 million tonnes, from several years of producing between 650,000 and 700,000 tonnes. That made the country not only the world's second-largest producer behind the Ivory Coast, but a force to be reckoned with as a swing producer.

In the early going of the 2011-12 campaign, government sources assured the market that this performance was to be repeated. As recently as mid-March, government estimates still put the crop size at close to 1 million tonnes. By the end of March, the estimate had slipped to 970,000 tonnes. A couple of weeks later it was 950,000 tonnes, and then dry weather was being blamed for yet another undetermined downward revision to the output estimate. On May 1 a story emerged that local buyers had overstated their purchases by 70,000 tonnes. That would put output back well below 900,000 tonnes.

We've long been skeptical of Ghana's ability to jump production by such a large amount in such a short period of time. Right now it seems as though the market has been in agreement over the past few months. The deficit forecasts were working with Ghanaian output of 1 million tonnes. We feel extremely comfortable increasing that deficit forecast by 100,000 tonnes

The market came awfully close to taking out our $2,050-per-tonne stop close, recommended on February 7. Remain long and maintain the same stop.

[May 3, 2012]

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Chart 8 – Combined butter/ratio spread

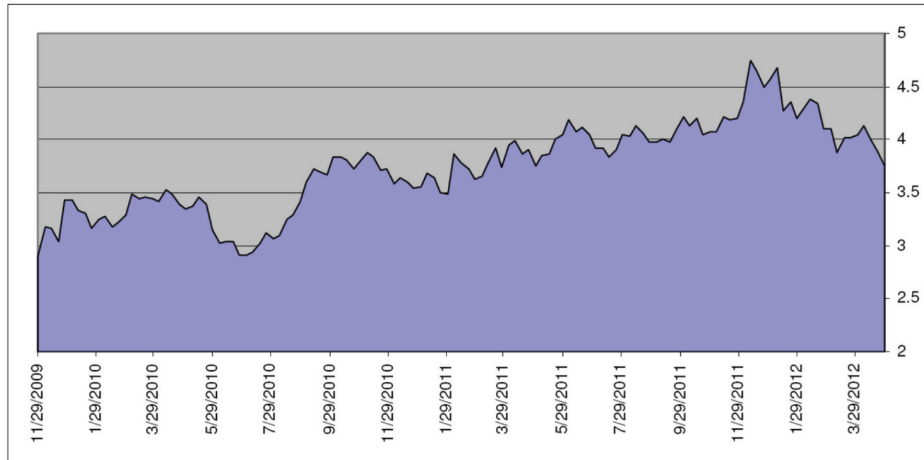

Chart 9 – July cocoa

Courtesy Reuters

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