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Falling wheat prices discourage production

After tumbling to multi-year lows in December, the wheat market strung together a 15% rally off the bottom. Most recently, prices have pulled back, erasing about half the gains (Chart 1).

As we near the end of the 2016-17 marketing year on May 31, the global balance sheet will show a second consecutive year of inventory buildup, with extraordinarily large ending stocks of 33.7% of consumption. The carryover for 2015-16 was 33.8% of usage. The average carryout for the previous five years was 28.7% of usage.

In the February 16 issue of *Focus on Futures* we discussed how farmers in Northern Hemisphere producing nations, discouraged by low prices, reduced planted area for 2017-18 crops to be harvested this summer. This was particularly true in the US where acreage fell to its lowest level in over 100 years and most likely provided the inspiration for the rally. Coming off a season of record global output, it's hard to see how wheat prices would have much upside potential. And in the short term we would agree that is the case.

However, as the old adage goes: "Bull markets beget bear markets, and bear markets beget bull markets." This is true especially for agricultural markets in which farmers respond rather quickly in terms of planted area based on how well they can hedge their forthcoming crops.

Taking a look at the Southern Hemisphere crops, there are two principal Southern Hemisphere exporters – Australia and Argentina – which account for roughly 20% of world trade. The March USDA crop report updated its 2016-17 estimates for these two countries to reflect post-harvest results. Argentinean output was revised up by 1 million tonnes, to 16 million tonnes. The USDA is being cautious, though. Private forecasters put the crop at 17 million tonnes, and the government estimate is even higher at 18.3 million tonnes.

The USDA bumped up the Australian crop by 2 million tonnes, to a record-by-far 35 million tonnes, in line with other estimates.

Turning to the 2017-18 marketing year, however, prices remain unattractive for farmers who are making planting-area decisions now. It would seem that Southern Hemisphere wheat producers will be following their Northern Hemisphere counterparts.

Informa Economics published an early forecast for Argentina's new crop that will be 10% smaller than in 2016-17. In any case, the variance on Argentinean output is not as significant as it is for Australia. Even after an upwardly revised estimate of 2016-17 exportable surplus of 10.1 million tonnes, it pales in comparison to Australia's 25.5 million tonnes.

The record 35-million tonne Australian crop was a flash in the pan. Far from establishing a new output trend, the size of the 2017-18 crop, to be planted starting in late April, is expected to plunge. Planted area will be smaller, but not by that much. The real issue is that the past two crops benefitted from exceptionally wet weather, escaping any El Niño effect. Forecasters are predicting an end to that run of luck, saying that a 50% chance of another El Niño will see a return to drier conditions. ABARE, the Australian equivalent of the USDA, is forecasting that output will fall by an astounding 32%, to 23.98 million tonnes!

It will take time to work off the burdensome ending stocks carried over from the 2016-17 marketing year. By the same token, with smaller crops in 2017-18, most notably in the US and Australia, the vulnerability to crop failures – even in countries that will not see a significant drop in planted area – will hang in the background.

Commodity funds covered a significant chunk of their net-short positions during the recent rally. As Chart 2 illustrates, though, they retain a material presence on the short side, which will be covered down the road if and when bull-

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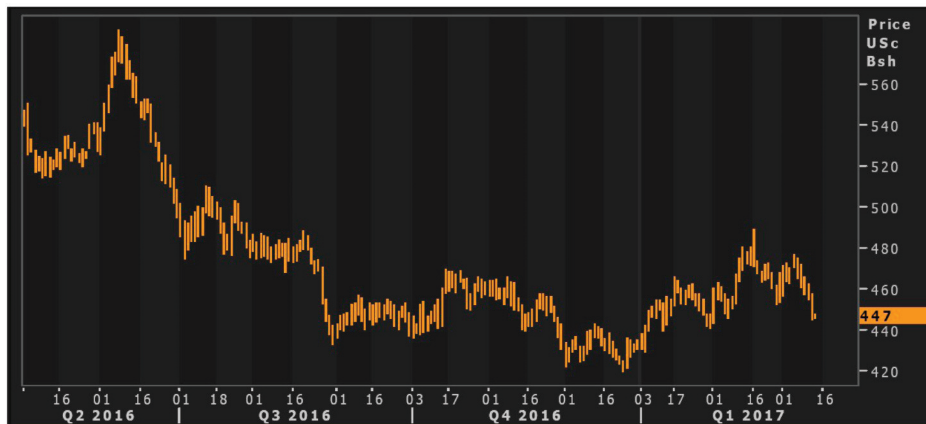
ish fundamentals surface.

It may be premature to become very bullish on this market, but we believe that the bear market is drawing to a close, and there is limited downside. We suggest treading cautiously. We maintain our February 16 recommendation to establish moderate long positions in July wheat with a stop close at 4.30 per bushel.

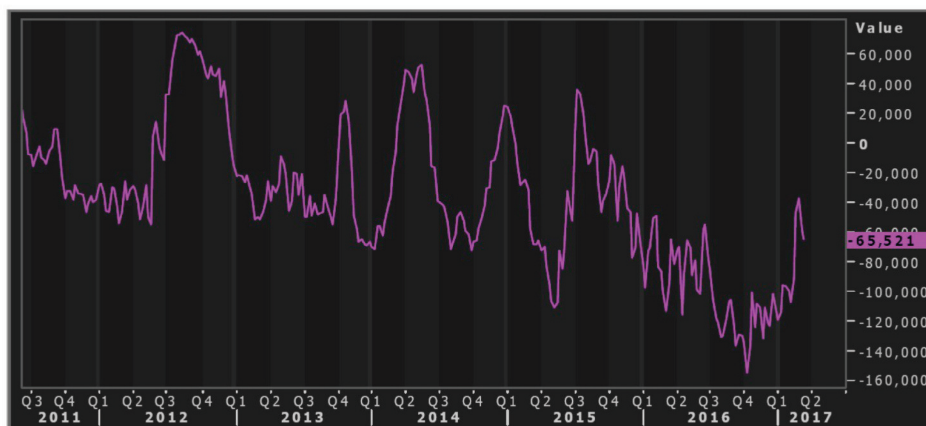
[Sholom Sanik, March 14, 2017]

Chart 1 – July wheat



Courtesy Reuters

Chart 2 – CFTC commodity fund net-short position



Courtesy Reuters

CORN

Will bin-busting South American corn crops sustain the bear market?

Brazil and Argentina are slated to harvest record corn corps this spring and summer for the 2016-17 marketing year.

For Brazil, the 2015-16 crop was a drought-plagued disaster. Output fell sharply, to 67 million tonnes, down from an average of 82 million tonnes in the three previous seasons. In its March crop report, the USDA raised the estimate for 2016-17 output, to 91.5 million tonnes from the 86.5-million-tonne February estimate, handily beating the average of analysts' guesstimates of 87.78 million tonnes.

When the Argentinean export tax was first eliminated, we were skeptical that the fantastic estimates for 2016-17 corn production being thrown about were achievable. We were wrong. Farmers took full advantage and expanded planted area. The USDA revised its February estimate by 1

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million tonnes, to 37.5 million tonnes. That compares with an average of 28.85 million tonnes in 2015-16 and 2016-17.

Despite appearances, these explosive results from South American producers have not bolstered ending stocks by much. Total global production was revised upwards from the February estimate by 9 million tonnes, but the USDA increased its consumption forecast by 6.5 million tonnes. That pushes the global ending stock estimate up slightly to 220.68 million tonnes, or 21.2% of usage, compared with the February estimate of 21.06%. Actually, that figure is down from 21.3% and 21.90% in 2014-15 and 2015-16, respectively. And that's because while global output grew by 9% in 2016-17, demand is expected to grow by 8.2%.

The forecast for stronger demand is on solid ground. The USDA estimate for US exports in the current marketing year calls for a 17% increase, to 56.52 million tonnes. The weekly export commitment tally, however, is still showing the possibility of an even greater increase.

According to the most recent data, commitments stand at 46.7 million tonnes, 52% ahead of last year at this time. Naturally, we cannot expect the current pace of exports to last much longer. Even in years of strong demand, US foreign sales begin to give way to South American origins by June. But as long as new sales are maintained at a historical norm, there is a very good chance that the USDA will have to increase its estimate for US exports in the coming months.

Looking ahead to 2017-18, the relationship between new-crop corn and new-crop soybean prices can be volatile in the short term, but overall the ratio has not strayed far from the historical norm. It would seem, however, that during the critical moments when farmers plan their crops and are surveyed as to their planting intentions, they were more bullish on soybeans. As a result, preliminary USDA forecasts out of the February USDA Forum show a sharp increase in soybean planting at the expense of corn. Soybean acres were estimated at 88 million acres, up 4.6 million acres from 2016-17. However, corn area is expected to fall by 4 million acres to 90 million acres.

Private forecasters believe that the estimated cut in corn acres was too steep and put corn area closer to 91 million tonnes. Either way, with prices still near multi-year lows, the planting attitude towards corn could have a ripple effect, and we might see other Northern Hemisphere exporting countries follow a similar pattern. With smaller crops and persistent demand growth in 2017-18, we're likely to see global inventories drawn down. As illustrated above, it is not as though the huge crops in the US and South America padded inventories.

There is no overtly bullish case. By the same token, smaller crops in an environment of strong demand would magnify any weather-related problems. Prices are likely to remain range-bound for the foreseeable future, but the bear market has ended.

Remain long as per our January 18 recommendation, and maintain stops at $3.40 per bushel, basis the nearest contract, close only. *[By Sholom Sanik, March 23, 2017]*

Chart 3 – May corn

Courtesy Reuters

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SUGAR

The bitter sweet

Long-suffering mills in the world's two largest sugar-producing countries, Brazil and India, struggled to pay their bills because of depressed prices. They were bailed out by two consecutive seasons of global production/consumption deficits that pushed prices back up.

Between August 2015 and October 2016 sugar prices more than doubled. Aside from the occasional setback, the market rose almost uninterrupted. Over the past several months, however, the market has shed about half of those gains (Chart 4). Is the bull market over?

Some analysts say that we can count on a return to normal crops and that the deficit period has ended. The 2017-18 marketing year will move back into a modest surplus. It's a bit early to be certain.

For Brazil, the new marketing year will begin over the next few weeks. The Center South cane crop is expected to be slightly smaller than in 2016-17. But Brazil did not have any material weather problems this past season and managed to produce record output of over 35 million tonnes of sugar. Early forecasts are looking for 2017-18 output to roughly equal this past season's.

The supply-side issues lie in Asia, particularly in India. For a good part of the season, official government estimates for 2016-17 maintained that output was close to 24 million tonnes. We're on record (see *Focus on Futures*, January 6) as saying that with the disastrous drought in the largest production province, Maharashtra, those estimates were near impossible.

The government has toned down its exuberance, and the official estimate is now 20.3 million tonnes. Private estimates are as low as 19.6 million tonnes. But that is no longer of significance because the market obviously knew that the figures were too high.

The question now revolves around this year's monsoon. Over the past couple of months, meteorologists have been talking about the chance of a return of El Niño. It is not a high probability – at present they are talking about a 50% chance.

India cannot afford another El Niño-induced drought. Although the estimates vary, one thing is for certain – ending stocks are at their lowest level since the drought years of 2009 and 2010. Since then, domestic demand has grown steadily, to about 25 million tonnes, which means a 5-million-tonne deficit. The government has been under pressure to eliminate existing import taxes, but claims that imports will not be necessary. Perhaps, but then inventories will be run down to historic lows. The attitude is on par with the ill-advised program that sought to force exports last year. In any case, they had better get good weather.

El Niño-related drought – if it occurs – is not limited to India, but would be prevalent in the rest of the continent and Oceania as well. Thailand and Australia are key exporting nations.

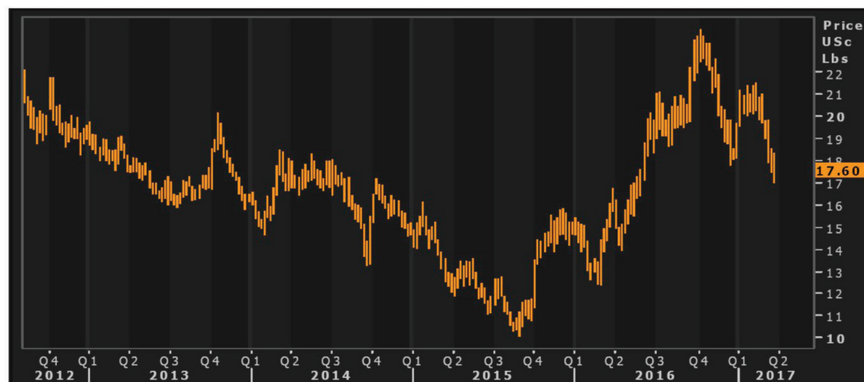
China has become a significant importer over the past few years. The Chinese went from 14-million-tonne crops to below 10-million-tonne crops over the past two seasons. That leaves a huge gap between production and consumption of 4 million to 5 million tonnes. Part of the gap will be filled by sales from state reserves, but it's a safe bet that imports will continue to grow. Rain in the Eastern Hemisphere is absolutely crucial.

Commodity funds have thrown in the towel on this bull in anticipation of a return to normal Asian crops. Chart 5 shows that the net-long position has fallen from 290,000 contracts in October to just over 100,000 contracts.

We respect this possibility, and as such, we are not recommending any new investment in the long side unless the monsoon underperforms. By the same token, we advise holding on to previously purchased October 22 calls.

[By Sholom Sanik, March 24, 2017]

Chart 4 – Nearest contract ICE sugar



Courtesy Reuters

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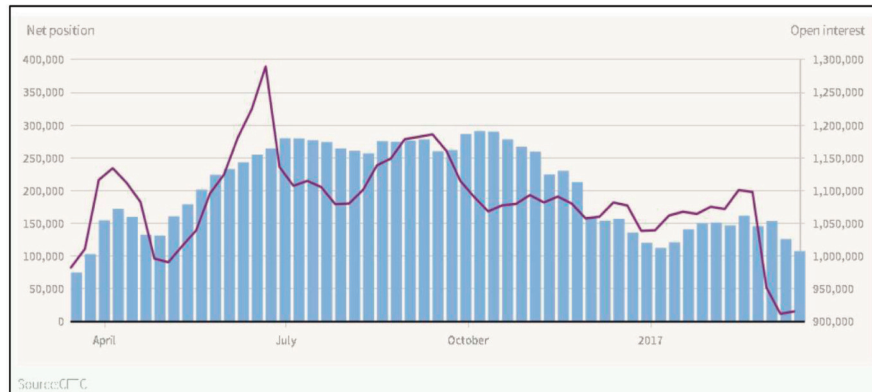
Chart 5 – Commodity fund net-long position



Source: CFTC

COTTON

Higher prices inspire large crops: Exit the bull?

In the weeks leading up to the March 31 USDA report that would provide survey results of how many acres farmers intended to plant for each of the major US crops, cotton prices traded up to three-year highs. The informal estimate out of the USDA Forum held in February indicated that US cotton area for the 2017-18 marketing year to be planted this spring would be expanded by about 15% over the previous season. That must have made commodity funds a little nervous. CFTC data showed that the net-long position was trimmed by close to 6,000 contracts in the three weekly reporting periods prior to the release of the planting intentions report.

The average of analysts' guesstimates called for 11.49 million acres, with the "whisper" number closer to 12 million acres, compared with 10.07 million acres planted in 2016-17. The actual figure came in at 12.233 million acres. The reaction to the report was certainly a bit strange. After a brief sell-off, in old- and new-crop contract months, the market closed sharply higher for the session. After having a chance to digest the implications of the largest area planted to cotton since 2012, the following session saw some heavy selling that ended with a classic downside outside-day reversal in spot May (Chart 6). Where do we go from here?

Unfortunately it is too early for any 2017-18 forecasts for the world's two largest producing countries – India and China. The conditions that inspired the increase in US area may very well be prevalent in other countries as well. It is safe to say that cotton prices have been the strongest performer among the world's major agricultural commodities over the past several years (Chart 7).

One forecast puts world output at 113.5 million bales, up about 8% from 2016-17. That may seem a bit overwhelming, and on the surface it may be difficult to see how prices can be maintained at these levels. But consider several factors:

Unlike many other commodities, the jump in production is still well below levels reached in previous years. Global output peaked in 2011-12 at 127 million bales, and through 2014-15 averaged 122 million bales. In 2015-16 and 2016-17, output averaged only 100 million bales because of a combination of falling prices and poor weather.

Demand did not grow much during this period, but remained steady, and we are coming off two consecutive seasons of sizeable production/consumption deficits. Now, it is quite true that a couple of years of restrained production was necessary to eat away at the ridiculous global carryout, which at one point equaled over 100% of global usage. That task, however, may well have been accomplished already.

With so little information about the new crops in India and China, it would be impossible to take a stab at an estimate for the 2017-18 ending-stock figure at this point. But we should end this season at about 80% of usage. Inventories still seem too high?

Demand has experienced something of a revival. The USDA estimates 2016-17 US exports at 13.2 million bales, up 45% from 2015-16. To date, there has been no letup in the torrid pace of weekly sales. At last count US exporters had commitments of 12.3 million bales, up 70% from the same time last year. And there are close to four months remaining in the marketing year.

The most important issue that does not make the head-

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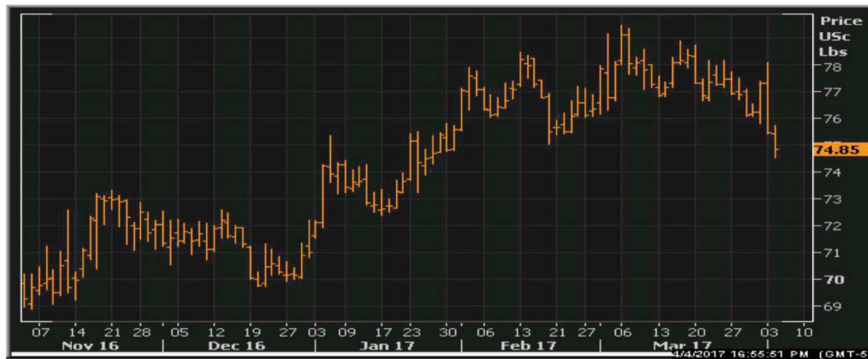
lines – and something we've mentioned several times over the past year (see *Focus on Futures*, February 8) – is a misread of the "burdensome" Chinese stockpiles that make up over half of the global ending stocks under discussion. The government has been selling them off – hence the sharp drop in imports over the past few seasons. Whatever is left is of poor quality and has only marginal utility for mills that manufacture fabric for export to the US and Europe. So that bulging ending-stock number is going to be a fixture on the USDA balance sheet for the foreseeable future, but it means very little.

In fact, we would take an educated guess that by 2017-18, we could see the Chinese import figure begin to rise as Chinese mills will be back in the market for higher-quality cotton.

We expect prices to stabilize after the market absorbs the news of a larger US crop and then perhaps bigger crops in India and China. Remain long July cotton. Maintain stops, as per our February 8 recommendation, at 72¢ per pound, basis July, close only.

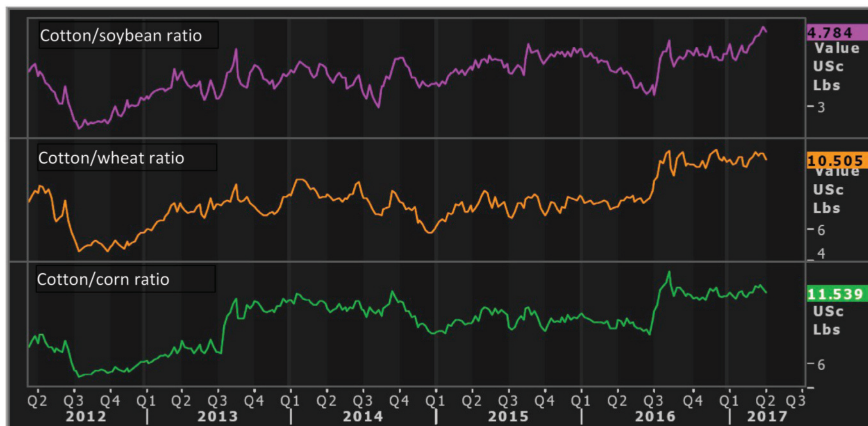
[By Sholom Sanik, April 4, 2017]

Chart 6 – May cotton



Courtesy Reuters

Chart 7 – Cotton ratios: soybean, wheat, corn



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Subscription Enquiries for
Friedberg's Focus on Futures
Suite 250
181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
416-364-1171

All enquiries concerning trading accounts should be directed to:
Friedberg Mercantile Group Ltd.
Suite 250
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

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