# FRIEDBERG'S

FOCUS ON FUTURES

Friedberg Commodity Management Inc.

Volume 3, No. 8 September 5, 2000


# Cocoa: who's in charge?

There are two distinct forces at work in the cocoa market, and both are struggling to determine its price.

On one hand, we have the supply and demand fundamentals. A superficial glance makes it seem that the market is well supplied and that the multi-year downtrend in prices merely reflects the economic realities of the cocoa market. The world's biggest producer, the Ivory Coast, harvested another bumper crop of 1.3 million tonnes for the 1999-00 season. Global ending stocks won't budge from their perch and are equal to about 40% of consumption – very high for any commodity. The current marketing year will end with a production/consumption surplus of almost 100,000 tonnes.

The future, however, looks much brighter. In its August 15 report, E.D. & F. Man cast doubts on the prospects of another record crop in the Ivory Coast. "Despite favourable soil moisture conditions, the recovery in new crop prospects that was apparent in June and early July has not been sustained in recent weeks...main crop arrivals next season are likely to fall short of the 1990/00 total." The market ignored completely this bit of seemingly vital information. True, it is very premature to talk about actual figures for the 2000-01 crop. But we find it amazing that potentially bullish news of this nature would not even inspire a one-session rally. More on this later.

The big story on the bull side is demand. Man says that second-quarter grindings grew 7.9% and pegs growth for the year at 8.9%. This is a far cry from the 2% to 2.5% growth in global grindings that has been recorded in the past few years.

The bears have a counter-argument. They say that while it is quite true that processors have been grinding beans at a much faster pace than they have at anytime in recent memory, stockpiles of the end products – butter and powder – are building up. Man points this out in its report, as well.

Grindings have always been used in the cocoa market as the benchmark for consumption. It has been an imperfect system, because it doesn't monitor the level of end products consumed. We don't remember anyone complaining about the imperfection of the system when grindings were just limping along all these years.

In fact, we believe that the buildup of stocks in the end-products is very bullish. The processors would not be grinding if they were not getting ready to use the products. They have to purchase the beans, absorb the expense of grinding them, and then store the products. In the age of just-in-time-inventory, why would anybody risk the grinding process if they weren't projecting solid demand?

The Asian crisis delayed consumption growth for chocolate and other luxury items in developing countries, but did not kill it. We have no evidence that Asians, Russians, or Eastern Europeans are going to be buying more chocolate, but economists who work for multi-national corporations that process cocoa beans certainly seem to have such information.

Why then is the market so weak?

Commodity funds are having a field day, even though the spot price of cocoa hasn't moved very much at all. Although the headlines on commodity pages in the media report every new contract low in cocoa, they don't tell us that in previous

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dips the spot price was actually lower (Chart 1). The burdensome stockpiles have ensured consistent carrying charges that at present are running at 15% per annum. This has allowed anyone who is not in awe of the potentially explosive bullish fundamentals to maintain a short position and "collect the contango."

This explains why even bullish news does not cause rallies. Traders for commodity funds stand waiting with their sell tickets in hand to pound the market on even the smallest uptick. Cocoa open interest currently sits at 115,000 contracts (Chart 2). We would describe this as an "unnatural" level, i.e., it is far larger than would normally be required to facilitate commercial hedging. To illustrate, consider the corn market. The current open interest of about 400,000 contracts represents roughly 20% of US corn production. The open interest of the New York and London (Chart 3) cocoa markets combined is equal roughly to the entire global crop! It's a game that cannot last forever. Ultimately, prices become too cheap, farmers are not paid enough to maintain quantity or quality levels and scarcity appears.

It is impossible to put a number on the 2000-01 crop at this stage. Nevertheless, early indications are that there will be no extraordinary output increases in the crops of any of the major producers, particularly and most significantly the Ivory Coast. If grindings continue at their current pace, we will surely have a production/consumption deficit. Eventually the shorts will come to realize this and glance up at the board. They'll find cocoa prices at ridiculously low prices, and a massive short covering rally will ensue. *[August 21, 2000]*

***STRATEGY:*** *Remain long December cocoa as per Flash Update of August 11. Maintain stops at 765, close only.*

**Chart 1 – Spot Cocoa**

**Chart 2 – New York Open Interest**

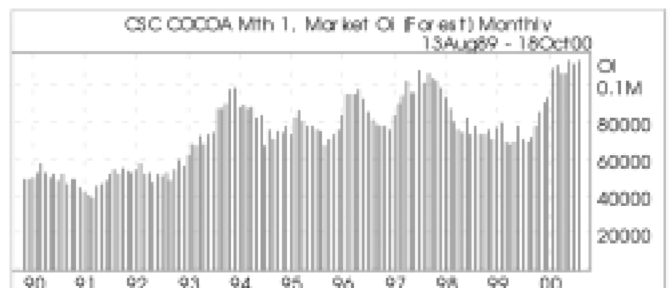
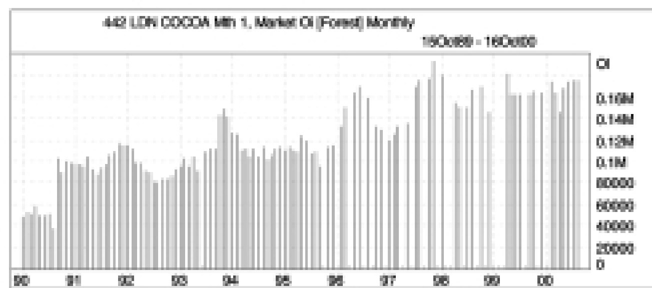



**Chart 3 – London Open Interest**




Charts courtesy of *Reuters*

## COTTON

# Hot, dry weather and strong exports yield a bull market

Early this year the cotton market was mapping out a price pattern almost in lock-step with other major US crops (Chart 4). The weather in the major crop regions has been as volatile as it has been in any year in recent history. Before the crops were even planted meteorologists were calling for a hot, dry summer. Prices rose sharply in anticipation of drought and the poor crops that would surely follow. A very dry spring depleted subsoil moisture levels; their forecasts were off to a good start.

Then came the rains, and they came, and they came. Subsoil moisture was restored, crops were developing beautifully – and early to boot – and corn, wheat, soybean, and cotton prices plunged. The weatherman was wrong.

Well, not completely. Cotton regions were not as fortunate as the grain areas, further north. When the rains came, spot prices retreated all the way back to 50¢ per pound – along with the grains and beans. But as the summer wore on, it became obvious that the cotton market was not going to enjoy the same bountiful supply-side fundamentals as the other US crops.

Hot and dry weather has been wilting the crop in key areas like west Texas and the Mississippi Delta. The forecast for Texan growing regions for the next few days is for temperatures to reach 90°F to107°F. In fact, the quality of the crop has been downgraded consistently for weeks now. On July 3, the USDA estimated that the "good-to-excellent" category represented 63% of the crop. According to yesterday's weekly progress report, that portion has been downgraded to only 47%.

Interestingly, this is the same percentage of "good-to-excellent" that was recorded at the same time last year, a year in which the US crop amounted to only 16.97 million bales compared with the USDA's estimate of 19.16 million bales this year. It is not as if the USDA expects this year's crop to be 13% larger because of increased acreage alone. Planted acreage is only 5% larger than last year. Yields too, expected to be 648 pounds per acre, or about 7% more bountiful than last year, must play along. Have the USDA analysts overshot in their estimates for production?

To be sure, the crop is in much worse shape than anyone would have believed a few weeks ago. Before the August 11 USDA supply/demand situation report, some analysts pegged the US crop to be as high as 20 million bales. The average guesstimate was 19.27 million bales. The estimate came in at 19.16 million bales. The weather has been so detrimental to the crop that many analysts are now talking about a crop as low as 18 million bales.

Turning to the global scene, the USDA again lowered its forecast for ending stocks for the 2000-01 season to 35.15 million bales from its July estimate of 36.05 million bales. To illustrate the significance, consider that last year's ending stocks of 40.14 million bales represented 44% of consumption while this month's revised forecast would put global ending stocks at only 38% of consumption. If the US were to end up with a drought-reduced crop of only 18 million bales, global ending stocks would drop to below 37% of consumption, or very close to the kind of inventories we had when cotton prices ran up to over $1 per pound.

This pessimistic-crop/optimistic-price projection is naturally taken with the assumption that demand will remain constant. The USDA estimates that US exports will grow by 20% in 2000-01 to 8.2 million bales. The marketing year began at the beginning of August, and we find US export sales of 2.6 million bales are running ahead of last year's pace by 23%. This, despite the very paltry sales that we've seen in the past few weeks, save for one blockbuster week when US exporters sold 285,000 bales, which was dramatically above a typical week's business. It seems that the market is experiencing some sticker shock. Nevertheless, the USDA forecast appears to be off to a good start.

The big story on the global scene was the sharp drop in Chinese ending stocks of almost 5 million bales from last year. While China still holds formidable inventories that represent 46% of consumption, it is a drastic change from last year when it finished its marketing year with stocks that stood at 67% of consumption. There is some debate as to whether actual consumption increased or whether the Chinese are just trying to deplete their burdensome stockpiles.

In conclusion, the fate of the US crop is so significant because it is by far the world's biggest exporter. While strong global demand is imperative, the more immediate concern is how much damage was done to the crop and what the weatherman in Texas can deliver from here on in. *[August 22, 2000]*

***CURRENT STRATEGY:*** *Remain long December cotton as per Flash Update of July 27. Raise stops to 63.50, close only.*

**Chart 4 – December Cotton (line) and December Corn (bar)**

Chart courtesy of *Reuters*

## SOYBEANS

# Uncooperative weather and strong exports yield an oversold market

World soybean output is running rampant. After a bit of an off year, production for the 2000-01 season stormed back to a record 169 million tonnes, an increase of 8% over the 1999-00 season. The world's biggest producer, the US, is the biggest contributor to the bounty, because it is expected to harvest a crop of 81 million tonnes, a jump of 13% from last season. Brazil, the number two producer, also harvested a record crop of close to 33 million tonnes.

Although the demand side is growing as well, it pales when compared with the 8% growth in output. In this month's supply/demand situation report, the USDA raised its forecast for 2000-01 consumption from last month's estimate by close to 2 million tonnes to – 165 million tonnes. This represents an increase in consumption over last year of only 3%.

Even though the 2000-01 production/consumption surplus shrank by 1.3 million tonnes from last month's estimate, the USDA raised its forecast for ending stocks by 2.7 million tonnes. The USDA "found" 4 million tonnes to add its previous estimate of 1999-00 ending stocks. The net effect is that ending stocks will grow to represent 17.5% of consumption compared with last season's 15% of consumption. All in all, not a terribly bullish picture.

Why then did the November soybean contract record its low tick on July 17 (Chart 5), almost a month before the bearish August 11 report? After all, the key figure in the report, the size of the US crop, came in over 1 million tonnes above the street's average guesstimate.

Well, for one thing, since the peak of the rally in early May that was prompted by a weather scare, the price of soybeans has dropped almost $1.50 per bushel, or 25% of their value. The market has wiped the slate clean of any fear premium. The term "oversold" comes to mind. Are there any factors on the horizon to watch for that might alter the outlook for this otherwise well supplied market? Is there any reason to believe that the recent strength is anything more than a correction in a bear market that began in mid-1997 at $9 per bushel?

This year's US crop has been developing at an optimum pace in all categories. The percentage of plants setting pods was 91% as of the latest progress report (August 21) compared with the 5-year average of 80%. Some 65% of the crop is rated good-to-excellent compared with the rating at this time last year of only 48%.

The past two weeks, however, have seen hot and dry weather cover some of the key growing areas in Alabama, Georgia, and the Mississippi Delta. There is concern that some significant stress may have occurred and that it may show up in tomorrow's crop progress report. Although the crop is expected to be large enough to absorb some losses, we believe that current price levels allow absolutely no room for anything to go wrong.

On the demand side, the USDA raised its estimate for US exports by just over 1 million tonnes this month, to 27.5 million tonnes. This past season, US exporters sold 26.5 million tonnes. Last week's export commitments were very lame at 283,000 tonnes and significantly below traders' expectations. Still, the market has been firm since that report was released Thursday morning and even aside from the weather issue, it is not difficult to understand why. A closer look at recent export activity paints a picture that is consistent with ideas that the street is underestimating demand. Soybean meal exports in the most recent period were almost double the high end of traders' estimates and the best figure in months. Average bean and meal exports for the past 4 weeks were 608,000 and 107,000 tonnes compared with 364,000 and 114,000 tonnes respectively for the average of the previous 4-week period.

In the weeks that bean exports have been sluggish, meal exports picked up the slack. In the past two months, weekly meal exports were considerably stronger than published expectations. It really doesn't matter where the strength is; ultimately beans are crushed into meal.

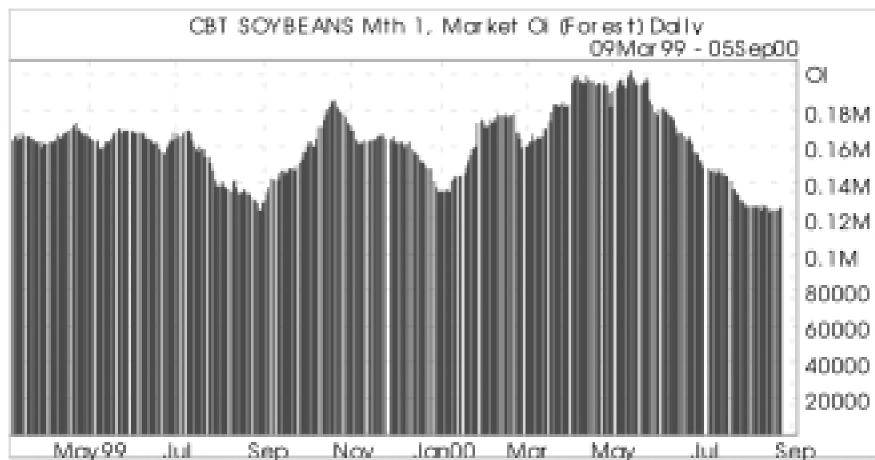
In conclusion, our foray onto the long side is not a bold statement that claims the bear market in the soy complex is over. Rather, we are saying that at these price levels, traders are calling for a perfect crop and average consumption growth. Recent weather and export numbers indicate to us that these traders are a shade too optimistic.

One final note: Open interest has plummeted (Chart 6) along with the downdraft in prices, providing evidence that any contingent of weak longs has been shaken out. *[August 27, 2000]*

***CURRENT STRATEGY:*** *Remain long November soybeans as per Flash Update of August 23. Raise stops to 4.60, close only.*

**Chart 5 – November Soybeans**

**Chart 6 – Soybean Open Interest**




Charts courtesy of *Reuters*

***ROUNDUP***

# Commodities on the move

The Bridge/Commodity Research Bureau index (CRB) made a new recovery high today at 228. The index has not seen this level since the darkest days of the Asian crisis and is now 25% above the lows set about one year ago. Is it fair to say that the strength of the index is making a strong statement about commodity prices in general? Probably not. We can divide the components into two categories, strong and weak. The strong are very strong, the weak are very weak. Seven of the 17 components are trading at multi-year highs, the other 10 are either at multi-year or one-year lows. Of the seven strong commodities, three are energy-related. The breadth of the index would thus indicate that the rally is led by a few select commodities.

Last November we made the argument that being long the CRB Index was the best way to capitalize on the recovery in commodity prices. A glance at Chart 7, however, shows that the CRB Index looks suspiciously like a chart of crude oil. This, and our trading experience with the CRB Index, has inspired us to rethink our strategy.

Still, with strong economies in the developed and emerging countries, it is clear that demand continues to improve. Many commodities, even the strong ones, continue to trade at prices that are cheap relative to average prices of the past 10 years. While the strength in energy prices does tell us something about the economy in general, it has proven to be of little assistance as an aid in trading the other commodities in the index. There is no replacement for meticulous research of the fundamental factors that drive each commodity on the board, supported by selected technical analysis.

We currently have five outstanding recommendations; all are long commodity positions. Three are from the strong group (cotton, copper, and sugar). In the other two posi-

tions, soybeans and cocoa, we are groping for a bottom. We've commented on cotton, cocoa, and soybeans this month. The following is a brief overview of the copper and sugar markets.

# Copper

The most recent news in the copper market was released on August 29 and the headline was not bullish. Copper production in Chile rose 10% for the month of July compared with July 1999. The market spent a bit of time in negative territory the day of the report, but finished the session by smashing through the top end of the tight range that the market has been trapped in for over a month (Chart 8). Traders treated this item as an anomaly because all the broader indicators have been showing that the period of monstrous growth in copper production we've seen in the past five years is over. Earlier this month, Chile's National Mining Society reported that Chilean copper output will grow 2.2% in 2001. This compares with 5% growth in 2000 and 18% growth in 1999.

At the global level, the International Copper Study Group stated in its August report that the production/consumption deficit for the first five moths of the year stands at 230,000 tonnes. At the end of April the deficit was 46,000 tonnes. Global production in the same period grew at only .5% compared with the same period last year, while consumption grew at a rate of 9%.

LME warehouse stocks continue to plummet and now stand at 448,000 tonnes, having fallen 400,000 tonnes from their peak two and a half years ago. The bullish case is solid.

***STRATEGY:*** *Remain long December copper. Raise stops to 85.00, stop close only.*

# Sugar

For weeks now, there have been few fresh developments in the sugar market's fundamentals. On August 23, the International Sugar Organization announced that it pegged the production/consumption deficit for 2000-01 at 5 million tonnes. Traders yawned. Although a bit higher than some previous estimates, it was hardly shocking news. If anything, whatever news did come across was slightly bearish. There was a story that EU output might come in 500,000 tonnes higher than expected. The Brazilian government continued to ratchet the acceptable ratio of the widely consumed gasoline/ethanol mix to a lower ethanol content. Indian exports in excess of 1 million tonnes hang over the market.

One of the fascinating aspects of this bull run in sugar has been the pattern in the open interest (Chart 9). Typically, our experience has been that rallies in sugar attract a huge contingent of speculators. This was the case for the first leg of the rally. But when the market consolidated between 8¢ and 9¢ per pound from the middle of June through the middle of July, traders apparently figured that the move was exhausted and a massive liquidation took place. Open interest has dropped some 50,000 contracts since then.

The composition of the open interest is not ideal in terms of the breakdown of the two groups, commercials and speculators. According to Steve Briese, author of *Bullish Review* (August 28), a newsletter dedicated solely to such matters, the commercial long position is only 30% of its typical size. Nevertheless, the relatively small speculative long position is not overwhelming and is therefore less likely to fall victim to massive selloffs.

The operative issue remains that the sugar market was hit with an unexpected turnaround in output because of dramatically poor crops in Brazil, Russia, the European union, and Australia. In one season we have turned from comfortable production/consumption surplus to steep deficits. The next upleg is around the corner. *[August 31, 2000]*

***STRATEGY:*** *Remain long October sugar. Raise stops to 10.15, close only.*

**Chart 7 – Spot CRB Index (Line Chart) and Spot Crude Oil (Bar Chart)**

**Chart 8 – December Copper**

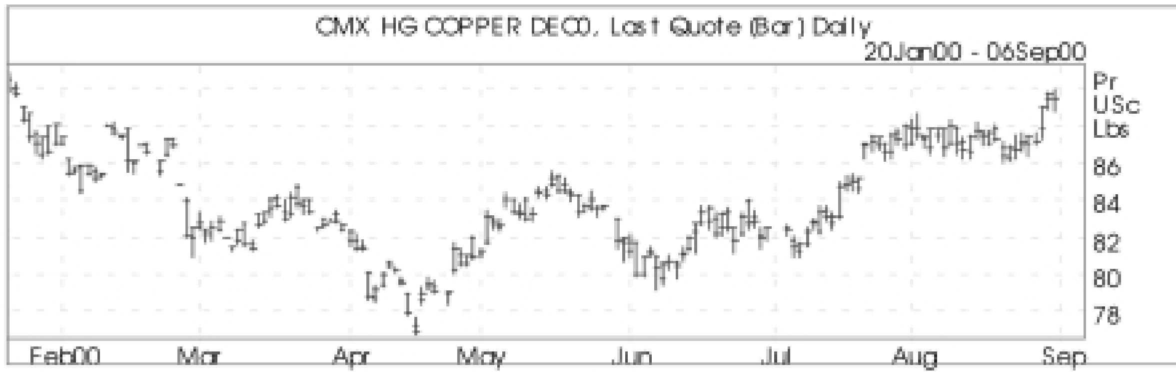
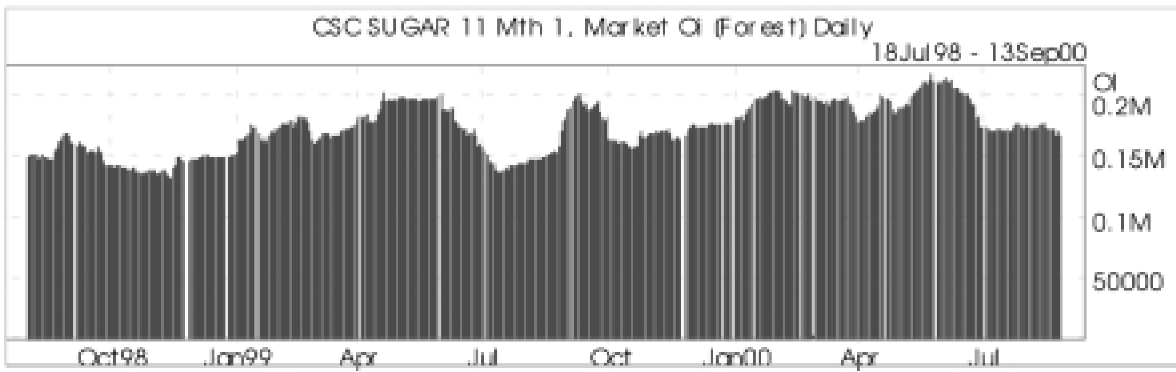



**Chart 9 – Sugar Open Interst**




Charts courtesy of *Reuters*

## HOTLINE UPDATE

***Flash Update:*** **Thursday, August 3, 2000:**
Good morning for Thursday, August 3, 9:15 am. This is a Flash Update. We have liquidated our long December gold position at 281.

***Flash Update:*** **Friday, August 4, 2000:**
Good morning for Friday, August 4, 10:00 am. This is a Flash Update. We have covered our short October crude oil positions at 28.75.

**Friday, August 4, 2000:**
Good afternoon for Friday, August 4, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long October sugar, with our stop revised to 9.85; long September copper, with our stop revised to 83.50; and long December cotton, with our stop at 58.50. All stops are close only.

***Flash Update:*** **Monday, August 7, 2000:**
Good afternoon for Monday, August 7, 12:30 pm. This is a Flash Update. We have liquidated our long October sugar position at 10.55.

***Flash Update:*** **Tuesday, August 8, 2000:**
Good afternoon for Tuesday, August 8, 1:15 pm. This is a Flash Update. We have liquidated our long September copper position at 85.85.

***Flash Update:*** **Friday, August 11, 2000:**
Good morning for Friday, August 11, 9:00 am. This is a Flash Update. We have purchased December cocoa at 815, placing our initial stop at 765, close only.

**Friday, August 11, 2000:**
Good afternoon for Friday, August 11, 5:00 pm. The following is a recap of our current open positions, and our latest stop levels. We are long December cotton, with our stop revised to 59.50, and long December cocoa, with our initial stop at 765. All stops are close only.

***Flash Update:*** **Monday, August 14, 2000:**
Good morning for Monday, August 14, 10:30 am. This is a Flash Update. We have purchased October sugar at 10.78, placing our initial stop at 9.78, close only.

**Friday, August 18, 2000:**
Good afternoon for Friday, August 18, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December cotton, with our stop at 59.50; long December cocoa, with our stop at 765; and long October sugar, with our initial stop at 9.78. All stops are close only.

***Flash Update:*** **Wednesday, August 23, 2000:**
Good morning for Wednesday, August 23, 9:15 am. This is a Flash Update. We have two new recommendations: We have purchased December copper, currently trading at 87.15, placing our initial stop at 82.70 close only. We have also purchased November soybeans at 466.75, placing our initial stop at 436.75, close only.

**Friday, August 25, 2000:**
Good afternoon for Friday, August 25, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December cotton, with our stop revised to 62.50; long December cocoa, with our stop at 765; long October sugar, with our stop at 9.78; long December copper, with our initial stop at 82.70; and long November soybeans, with our stop revised to 447. All stops are close only.

**Friday, September 1, 2000:**
Good afternoon for Friday, September 1, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December cotton, with our stop revised to 63.50; long December cocoa, with our stop at 765; long October sugar, with our stop revised to 10.15; long December copper, with our stop revised to 85.00; and long November soybeans, with our stop revised to 460. All stops are close only.

Friedberg's Focus on Futures is published by Friedberg Commodity Management Inc., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3.
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