FRIEDBERG'S
FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.
Volume 7, No. 7 August 3, 2004

With the annual Brazilian freeze all but gone, where are coffee prices headed?

The coffee market recently completed a rather classic seasonal pattern. A sharp rally in May, ahead of the Southern Hemisphere winter, attached a hefty premium to prices just in case there was to be a freeze. A drop below the freezing mark – even for just one night – could damage crops significantly. There were several freezes in Brazil in the 1990s, which resulted in dramatic crop losses and soaring prices. The weatherman had threatened a number of cold snaps over the past couple of months, but nothing serious materialized, and the entire rally was unwound. September coffee has now fallen 20¢ per pound from its peak set in late May, a slide of more than 20%.

With each passing day, the risk of frost is fading. The speculative community's enthusiasm for the long side has evaporated. Open interest has shed over 25,000 contracts from its peak of 117,000 contracts. The commodity fund net-long position has been whittled down from a high of 30,000 contracts at the beginning of June to several hundred contracts. Now that the market has headed back into the pre-frost-watch 60¢- to 70¢-per-pound range, traders will turn their attention to other potentially market-moving forces.

The primary issue, of course, is the size of the 2004-05 Brazilian crop. The early, very optimistic, forecasts, which reached as high as 50 million bags, are long gone. The range of estimates has slid down to between 36 and 42 million bags. Wet weather has affected the crop by delaying the harvest, which in turn lowers quality when the beans are left out on the field after they are ready for picking. By July 19, only 56% of the crop had been harvested, compared with 70% at the same time last year. Although the crop will still be considerably larger than 2003-04 output of 29 million tonnes, it is fair to say that it is disappointing. Still, the range of estimates for Brazilian coffee is notoriously wide, and with a good chunk of the crop yet to be harvested, it is premature to assume anything. In fact, at 42 million bags, the USDA's forecast – the highest and the most non-partisan estimate in the fray – is at the high end of the range.

Production estimates for Vietnam, the world's second largest producer, have been rising, and now stand at 15.8 million bags, close to15% above 2003-04 output. Its harvest normally begins in October, but press reports have indicated that the harvest could begin late this year because of irregular rainfall. Bean size is reportedly smaller than last year at this point in the season.

Looking at the global picture, on July 21, F.O. Licht revised 2003-04 production upwards by 3 million bags from its November estimate, to 105.4 million bags. It also raised its consumption estimate upwards, but only by 1 million tonnes, to 113 million tonnes. The sub-par 2003-04 Brazilian crop was responsible for throwing the market into deficit, and the results of the new 2004-05 Brazilian crop will make all the difference between either a global surplus or another deficit.

Demand is not exactly on a tear, but has been rising steadily over the past few years. According to the International Coffee Organization (ICO), consumption has been growing by about 1.5% per annum. Licht makes a loose forecast for global consumption of 114-115 million bags, and says that with a Brazilian crop of 41 million bags, the market would be in balance. Anything below that would push the market into a second consecutive deficit.

According to the USDA, global ending stocks stand at 24 million bags, or about 21% of consumption. This repre-

Inside

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

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sents a much lower level of inventories when compared with other commodities in which a significant portion of world supply grows in a single region, making them vulnerable to a single catastrophic event (cocoa in West Africa and sugar in Brazil). The market survived the drop in supply in 2003-04, but can it sustain another surprise on either the supply or demand side?

While there is nothing extraordinary on the horizon at the moment, there are two longer-term macro issues that could have a bullish impact down the road.

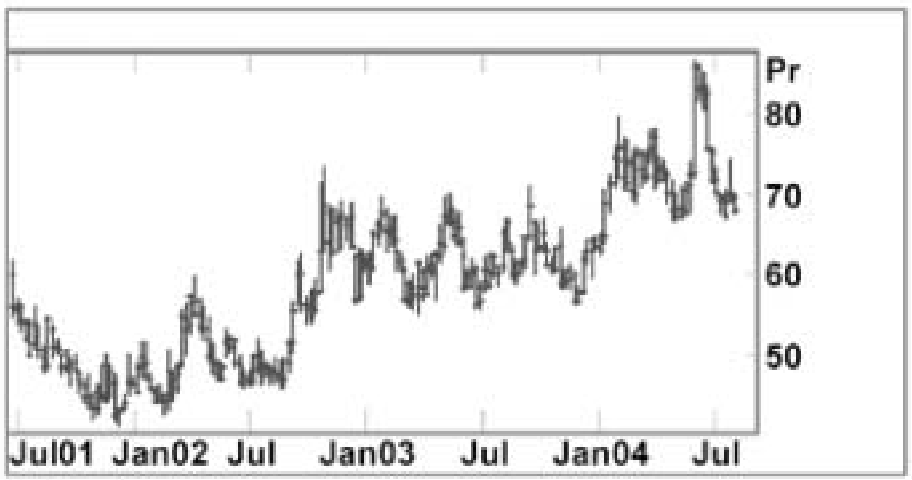
In Brazil, low prices have discouraged both new investment and optimum pesticide input. There has been a noticeable acreage shift to soybeans, corn, and sugar.

Second, there's a conscious effort afoot to market coffee in China. Brazilian trade delegations have been traveling to China to make their case. At present, even if savvy marketers were to successfully turn away even a small percentage of people from tea – the cultural staple – coffee is still far too expensive for the vast majority of the population. But we've read that marketers are in the process of creating a more affordable product for the Chinese market.

Neither of these two factors provide any grounds to run out and trade coffee from the long side. Indeed, as illustrated, the market is weak, and can easily continue lower. As the market toys with a second consecutive deficit, however, we feel confident that the ugly bear-market lows have been set. Given current conditions, there is little reason to expect the market to trade back down to those lows. Long-term investors with staying power may want to establish long positions on sharp post-freeze-scare liquidations. *[July 29, 2004]*

STRATEGY: *Remain sidelined, but stay tuned.*

Chart 1 – Coffee – weekly nearest contract



Courtesy Reuters

COTTON

Chinese output expected to soar

Over the past 9 months, cotton prices have fallen by a staggering 40¢ per pound (Chart 2). After two consecutive years of global production/consumption deficits, early estimates for the 2004-05 marketing year are for a return to a surplus. In its July supply/demand situation report, the USDA revised its forecast for world production upwards from its June estimate by close to 2 million bales, to 104.73 million bales. It also revised upwards its estimate for consumption, but only by 300,000 bales. The resulting balance will be a surplus of 4.5 million bales. This compares with deficits in 2002-03 of 10.37 million bales and 4.5 million bales in 2003-04. Ending stocks for 2004-05 will jump to 37.79 million bales, or 37.8% of consumption, compared with 33.5% at the end of the current marketing year.

The primary bearish factor is Chinese output. At the start of the 2003-04 season, China was expected to grow a record, 27-million-bale crop, based on planted acreage. But bad weather hurt the crop dramatically, and the final tally for the Chinese crop was a sharply reduced 22.3 million bales. This, and strong demand from Chinese mills, drove the market up to 85¢ per pound.

The USDA raised its forecast for 2004-05 Chinese output in the July report by 1 million tonnes, to 30 million bales. Because China has never grown a crop even close to that size, it remains to be seen how realistic this estimate is. Regardless, the outlook killed the bull.

US production for 2004-05 is expected to be 18 million bales, slightly below last year's output of 18.26 million bales. This represents a bit of an enigma, because throughout the planting season, our trade sources maintained that acreage will be lost to more profitable soybeans and corn. Prices of all US agricultural products have been tumbling, but as we illustrated in our May 7 discussion of cotton, soybeans in particular could have been hedged at prices that favored soybean over cotton planting by a wide margin.

Another rather strange phenomenon, and somewhat more puzzling, is the configuration of the open interest. We typically place a fair amount of stock in the activity of commercial traders, believing that their position in the market reflects collective intimate knowledge of the supply/demand fundamentals. Often, the timing of the signals provided by monitoring their activity is not perfect. In this case, however, the market topped last October. The commercials have maintained a net-long position, while speculative commodity funds have enjoyed the ride down with a lopsided net-short position, which, as of the most recent reporting period, still stands at 27,000 contracts.

The tumbling prices are solely the result of the *anticipated* increase in supply. The demand side – in terms of current activity and the outlook for the future – remains bullish. With 5 weeks left to the 2003-04 marketing year, US exports are in fine shape to meet and even exceed the USDA's forecast for 13.8 million bales. Commitments are actually ahead of the USDA estimate, and exporters need to ship only a minimal amount to hit the target.

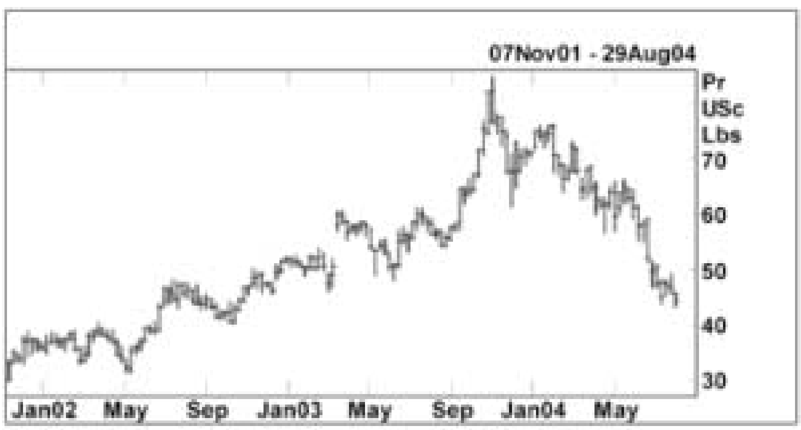
Because the USDA expects China to have a blockbuster crop, it forecasts US exports at only 11.3 million bales, down 2.5 million bales from 2003-04. In 2003-04, China took 4.6 million bales, or about 35%, of this year's US exports, which we cannot expect to be repeated if the Chinese crop comes in anywhere close to forecasts. Overall, though, the USDA estimates that 2004-05 global consumption will grow to 100.16 million bales, up from 98.39 million bales last year.

Although it's rather early to draw any conclusions about next year's exports, at 2.6 million bales, new crop commitments are off to a good start. This compares with only 1.5 million bales last year at this time.

In conclusion, it is clear that if all the cheerful production estimates come to fruition, these prices – and perhaps even lower prices – are well warranted. On the other hand, one wonders what motivates the knowledgeable commercial traders to have maintained their aggressive long position. We remain sidelined as interested observers. *[July 29, 2004]*

STRATEGY: *Remain sidelined, but stay tuned.*

Chart 2 – Cotton – weekly nearest contract



Courtesy Reuters

COPPER

Strong Chilean output has not alleviated the global deficit

The softening growth rate of the Chinese economy has broad implications for the global economy. As a direct consequence Chinese imports of commodities could slip resulting in price declines in affected markets. Copper, a commodity particularly sensitive to changes in GDP, has thus far not felt the impact. The market has staged a handsome,15¢-per-pound recovery from the lows of the corrective slide to $1.13 per pound and sits only10¢ per pound below the highs set in early March (Chart 3).

Commodities that have been heavily imported by China, such as soybeans, have seen a sharp drop in prices. Naturally, other factors played a role as well, but in the case of soybeans at least, a fallout in the financing infrastructure among crushers was directly attributable to changing economic conditions in China.

Indeed, press reports have indicated that similar conditions exist with Chinese copper importers who are finding it increasingly difficult to obtain credit to finance purchases.

Copper's strength is no great mystery. The internal supply/demand fundamentals remain bullish. Despite the fact that Chile, the world's largest producer of copper, continues to see impressive production growth, the global balance sheet remains in a steep deficit. Chilean production was rather weak at the beginning of this year. Output for January was down 1.3%, and February saw a small increase of 0.5%. Since then, however, monthly output has grown by an average of 7.8%. On July 22, the government lowered its production forecast for 2004 just a tad, but it still expects output for the year to grow by 9.7%. This compares with a 6.3% gain for 2003.

While Chilean miners are certainly doing their part to meet world demand, production at the global level is running behind last year's pace. In its most recent report, the International Copper Study Group estimated global mine output between January and April at 4.457 million tonnes, compared with 4.476 million tonnes for the same period last year. That is a difference of just under 0.5%. Consumption for the period, however, was 5.612 million tonnes, 450,000 tonnes above the comparable period last year, a jump of 8.7%. The resulting global production/consumption deficit stands at 513,000 tonnes, compared with 207,000 tonnes at the end of last April.

On July 27, Phelps Dodge Corp., the world's second largest copper miner, made some predictions about the copper market that were released together with its quarterly earnings report. It raised its estimate for the 2004 global deficit to between 600,000 and 700,000 tonnes from its 500,000-tonne March estimate. Despite the economic slowdown in China, it said Chinese demand would grow by 12%, up from its previous estimate 9%. Of course, Phelps Dodge stands to benefit from a rising copper price, so its comments should be taken in that context. While it may view the copper market optimistically, the numbers are quite commensurate with those of independent analysts.

Other gauges, which admittedly are lagging or coincident indicators and don't provide any solid predictive value, are nonetheless confirming that this market remains extremely tight for the moment.

LME warehouse stocks have dwindled down to next to nothing. As of July 28, stocks are 89,000 tonnes, down from 1 million tonnes in 2002 and from 450,000 tonnes at the beginning of 2004. Although not quite as stark, COMEX and Shanghai warehouses have also experienced similar depletions. As well, the market is in backwardation, with the September/December spread on COMEX at 3.3¢ per pound.

It is difficult to say with any certainty that the market has not already discounted the abundant bullish statistics cited above. It is clear, though, that we are not in a speculative bubble. The market has consumed whatever Chile has thrown at it.

One final point: Although China's economy may be slowing down, it is by no means grinding to a halt. The capitalist reforms that created the need for so much raw materials continue, albeit at a slower pace. Modernizing the country with Western-style structures is a process that will continue for a long time. There will be peaks and valleys, but demand for copper and for other commodities will endure in all areas where China is not self-sufficient.

We have attempted unsuccessfully to establish a long position on pullbacks. We definitely maintain a bullish bias, but we also intend to bide our time and tread cautiously. *[July 30, 2004]*

STRATEGY: *Remain sidelined, but stay tuned.*

Chart 3 – September copper

Courtesy Reuters

WHEAT

Estimates for global production continue to grow

The June USDA supply/demand situation report showed that the global production/consumption balance for 2004-05 was heading into its fifth consecutive season of deficits – albeit a small one when compared with the 40-million-tonne deficits of the previous 2 seasons. With the release of the July report, even that small deficit for 2004-05 is gone.

Global production for 2004-05 was revised upwards from the June report by a substantial 4.5 million tonnes, to 598 million tonnes. Consumption was revised higher as well, but only by slightly less than 500,000 tonnes. The expected 47.5-million-tonne recovery from 2003-04 in world output is staggering. In fact, there has never been a jump in global output from one season to the next of this magnitude.

Given normal weather conditions, these forecasts are not unrealistic. Both Western Europe and the FSU are coming off a disastrous 2003-04 season in which scorching temperatures slashed yields. Output for the two regions combined is expected to jump by 42.22 million tonnes. The estimates are merely for a return to normal output levels.

Although much smaller than last year, it is unlikely that there will be any surprises with the US crop. The most recent crop progress report showed that 83% of the winter wheat crop has been harvested. The good-to-excellent portion of the spring wheat represents 70% of the crop, a 2-percentage-point increase from the previous week. Last year at this time only 60% of the crop was rated in the top category.

The revisions in the July report will push ending stocks up to 132.24 million tonnes, or 22.18% of consumption, compared with 21.2% in last month's report. But in the grand scheme of things, the huge jump in global output is not going to alleviate the tightness by all that much. The years of production/consumption deficits drew inventories down to multi-decade lows, and this coming season's close-to-balanced market will not change ending stocks very much.

Although it's splitting hairs and is statistically insignificant, it is interesting to note that, at 22.22% of consumption, ending stocks for 2003-04 were actually a smidgeon higher than the forecast for 2004-05, even with the huge harvests that are expected.

The sharp fall in prices – the market is down well over $1 per bushel since early-April – seems well warranted, considering the prospects for bumper crops in the major exporting countries. A closer look at some issues that won't make headlines, however, leads us to believe that the market may be oversold.

As illustrated, the balance sheet has not improved very much. The sharp increase in FSU output will not have that much of an impact on food grade wheat, because, as Bill Gary points out in *Price Perceptions* (July 24), most of the wheat produced in Russia and the Ukraine poses more competition to the animal feed market than it does to milling-grade wheat.

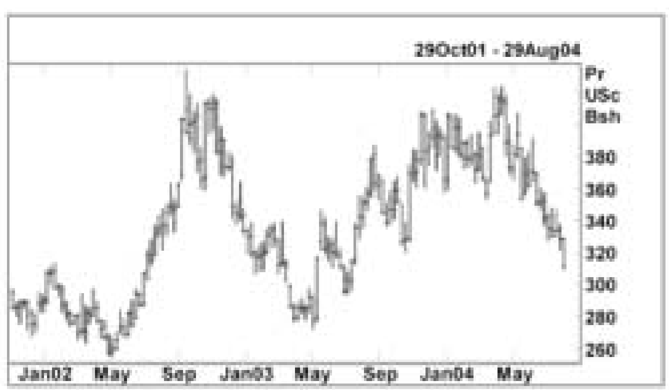
The US is still counted on to be the world's largest supplier of milling-grade wheat. But farmers planted fewer acres than last season, and coupled with lower yields for the winter wheat crop, the US will harvest 7.5 million tonnes, or 11.9%, less wheat than last year. The USDA has shifted the export burden on to the EU, lowering the estimate for US exports by 5 million tonnes from last year, and increasing EU exports by the same amount. Should any problem arise with the EU's crop, we could actually see ending stocks fall below last year's level by more than the insignificant amount cited above. In fact, while the USDA raised its estimate for EU output in July by close to 1 million tonnes, a more recent report by a French analyst lowered its EU estimate by 600,000 tonnes because of a revision in British acreage and dry conditions in France.

A glance at developments in the open interest shows that commercial traders are net-long and commodity funds have established a sizeable net-short position. The last time the funds were quite this short was just when the market bottomed at $2.70 per bushel in May 2003.

In conclusion, the outlook for a recovery in global crops has justifiably caused prices to slide. Even if the crop forecasts are accurate, however, demand estimates must be as well. Even a 1- or 2-million-tonne increase in consumption will draw ending stocks down below the level of the deficit years. We are not going to recommend a long position at this time, because prices still seem to be in freefall. Any indication that the crops of the major exporters are not going to meet the current rosy forecasts will stir our interest in trading from the long side.

STRATEGY: *Remain sidelined, but stay tuned.*

Chart 4 – Wheat – weekly nearest contract



Courtesy Reuters

HOTLINE UPDATE

***Flash Update* – Tuesday, July 6, 2004:**
Good morning for Tuesday, July 6, 10:55 am. This is a Flash Update. We have covered our short September mini S&P position at 1119.75.

Friday, July 9, 2004:
Good afternoon for Friday, July 9, 4:35 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On July 6 we covered our short September mini S&P position at 1119.75. We are currently holding no positions.

Friday, July 16, 2004:
Good afternoon for Friday, July 16, 4:15 pm. We are currently holding no positions.

***Flash Update* – Friday, July 23, 2004:**
Good morning for Friday, July 23, 11:20 am. This is a Flash Update. We have purchased December gold at 391.80, placing our initial stop at 379.50, close only.

Friday, July 23, 2004:
Good afternoon for Friday, July 23, 5:25 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On July 23 we purchased December gold at 391.80. We are currently long December gold at 391.80, with our initial stop at 379.50. All stops are close only.

Friday, July 30, 2004:
Good afternoon for Friday, July 30, 4:40 pm. The following is a recap of our latest recommendations and stop levels: We are currently long December gold at 391.80, with our stop at 379.50. All stops are close only.

Friedberg's Focus on Futures is published by Friedberg Mercantile Group Ltd., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3. Friedberg Commodity Management Inc., an NFA registered CTA, takes full responsibility for the contents of this publication.

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