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US cotton crop in trouble

In the June 5 issue of *Focus on Futures* we questioned the USDA's pessimism regarding the 2006-07 US cotton crop. The early forecast was calling for a sharp drop in production, to 20.7 million bales, down just over 3 million bales from 2005-06 output. The first crop condition report back in May showed the good-to-excellent portion of the crop at 43%, compared with the previous season's 60%.

The smaller US crop was the primary factor that resulted in the estimate for 2006-07 global ending stocks slipping into a bull-market zone of 38% of consumption. The 2004-05 and 2005-06 seasons ended with carryover stocks of 49.6% and 45.4% of usage, respectively.

The June 30 US planting intentions report supported our assertion that the estimate for the US crop was on the low side. The acreage estimate was raised by 650,000 acres, to 15.28 million acres. Based on the 88% harvested-to-planted ratio used in the June USDA supply/demand situation report, this would have added 900,000 bales to the estimate for the US crop. Prices had fallen by 5¢ per pound heading into the acreage report, and then tumbled an additional 3¢.

Drought conditions in the cotton belt, however, have changed the outlook considerably. This month's supply/demand situation report, released on July 12, lowered the harvested-to-planted ratio to 83.7%, which despite the larger number of acres, actually lowered the crop estimate to 20.5 million bales. The most recent crop progress report supported the market's worry about the crop, with the good-to-excellent portion falling 2 percentage points, to 38%.

It is summer, and there is nothing unusual about hot and dry weather and the rallies that invariably develop. We are far from an outright disaster on the one hand, but the USDA's skepticism has been vindicated. There's been significant abandonment of crops and – certainly at this point – there is little chance of coming anywhere near duplicating the last two years' output of over 23 million bales.

Only the question of yield remains, and that will depend on weather. For the moment, the USDA maintained its June estimate of 770 pounds per acre (ppa), but that can swing either way with the weather. To illustrate, consider that last

season the estimate for yield was 748 ppa in August, but grew to 831 ppa by the time the harvest was complete.

The growth of Chinese imports is the key demand issue for this market. Consumption is expected to leap to 51 million bales in 2006-07, up from 46.5 million bales this season and 38.5 million bales in 2004-05. With just a couple of weeks remaining in the marketing year, shipments of US cotton to China stand at 7.9 million bales, up from 2.5 million bales at this point last year. Chinese production for 2006-07 is estimated at 27.5 million bales, up from last season, but still shy of the 29-million-bale record output in 2004-05. There is no reason to assume that Chinese import patterns will not continue.

Clearly, the basis of the bearish case we developed in June is weakened. This past week's CFTC report showed that commodity funds still hold a sizeable net-short position. The market's strength over the past few sessions may just be the tip of the iceberg of a short-covering rally. We must therefore recommend the covering of short positions.

As we illustrated, however, yields for cotton (and other US crops) have shown some rather miraculous feats over the past few seasons, and we cannot discount the possibility of a continuation that trend. We have not turned bullish; our bearish stance is merely on hold. [July 24, 2006]

Inside

Soybeans: Boring	2
Wheat: Weather spurs bull	3

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Chart 1 – December cotton



Courtesy Reuters

SOYBEANS

Boring

A glance at a weekly chart of soybeans leaves one wondering if someone shut the ticker this past fall and nobody bothered to turn it back on (Chart 2). The spot price has moved in a tight band between \$5.60 and \$6 per bushel, about a 5% range, unique among virtually all the other commodity future markets on the board. It's not difficult to understand: bearish fundamentals kept prices from going up, but being in a broad-based commodity bull market environment kept them from going down.

The bearish case was downgraded to some degree by recent developments.

First, the June 30 planting intentions report showed that US farmers shifted acreage away from soybeans and into corn. The USDA slashed soybean area by close to 2 million acres from its initial March 31 estimate, to 74.93 million acres. In the weeks that followed the report, the market rallied 30¢ per bushel to reflect the expected decrease in supply. Using this new data, the July 12 crop report revised 2006-07 output downwards by 1.9 million tonnes, to 81.92 million tonnes.

Second, hot, dry weather in the Midwest is depriving crops of much needed precipitation. Crop conditions have deteriorated significantly since the USDA began monitoring this season. The good-to-excellent portion in early June represented 70% of the crop, but as of the most recent progress report has fallen to only 54%.

Although the August crop report is almost sure to lower the estimate for the US crop once again, supplies

should remain ample. To get an idea of just how tight the soybean market was for most of this decade and how the situation has changed, consider that in the 5 years prior to the 2005-06 season, US ending stocks were very low in historical terms, averaging 7.08 million tonnes (260 million bushels), and the trip to \$10.50 per bushel reflected that. But the combination of a near-record crop and a sharp 18% drop in exports in 2005-06 replenished inventories. Final ending stocks for 2005-06 rose to 14.82 million tonnes (545 million bushels), or 19.5% of consumption.

Looking ahead to the new crop, even after the acreage reduction, ending stocks are estimated to increase to 15.25 million tonnes (560 million bushels), or 18.7% of consumption, still well above historical norms of the past 20 years.

Aside from the fact that we're heading into a third year of large US crops, there are other issues that will in our view continue to keep prices moving sideways or lower.

Further on the supply side, Brazilian and Argentinean production continues to grow. Combined, the two countries produced 92 million tonnes in 2004-05 and 95 million tonnes this past season. For 2006-07, the (very early) forecast is up to 97 million tonnes. Thus, even in an environment where the fortunes of a US crop are threatened by weather issues, the global balance sheet will not be as affected as it was in the days when the US was the only producing country that was capable of supplying the needs of large Asian importers. In the 2001-02 marketing year Brazilian and Argentinean

exports constituted 40% of world trade. This past season their portion has moved up to 54%.

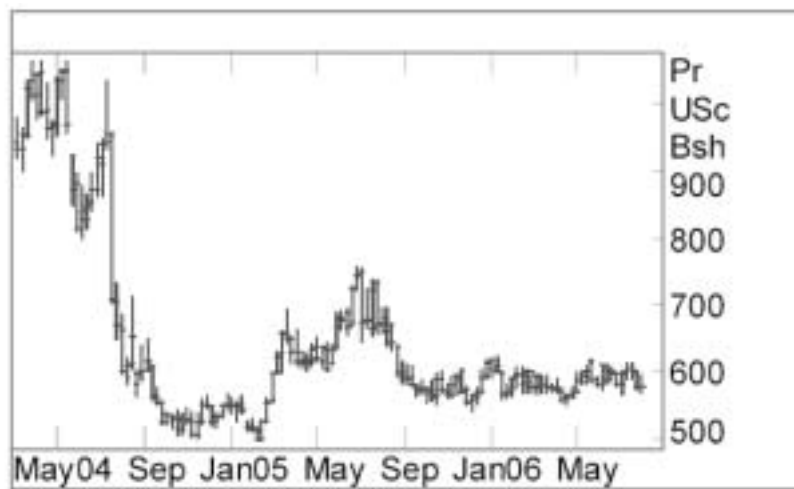
Demand for US beans fell sharply last season. Exports fell 18% from 2004-05, to 24.63 million tonnes. Early forecasts for 2006-07 are for a recovery back to 2004-05 levels.

Export sales over the past couple of months have been uninspiring, but one of the factors – and one that does not make headlines – that the optimistic USDA forecast is based on is that new crop sales are way ahead of last year's pace. As of the most recent commitment report,

contracted sales for soybeans stand at 3.39 million tonnes, compared with only 1.35 million tonnes at this time last year.

To summarize: The global balance sheet for 2006-07 will be slightly tighter than last year, but the estimates that this forecast is based on are all in very early stages, particularly South American output, where crops have not even be planted. Whatever negative impact the weather in the US Midwest has had on crops, it does not seem to have been too severe. We expect the market to continue to drift aimlessly. [July 28, 2006]

Chart 2 – Weekly soybeans



Courtesy Reuters

WHEAT

Weather intensifies bull market

The recent peak in wheat prices coincided with the release of the USDA's monthly global crop report and its detailed report on the US wheat situation (Chart 3).

For the US, 91% of the winter wheat crop has been harvested, and the results are dismal. A dramatic drop in the hard red winter wheat crop, to 660 million bushels from last year's 930 million bushels, brought total winter wheat production down to 1.28 billion bushels, compared with 2005-06 output of 1.499 billion bushels.

The spring wheat crop comprises only about 29% of the total US crop, but weather conditions were bad enough to affect enough of the crop to impact the big picture. Crop conditions deteriorated rapidly during July.

The good-to-excellent portion of the crop stood at 52% in the beginning of July, but has fallen to 32% as of the most recent crop progress report.

The estimate for global production was increased by over 5 million tonnes, primarily because of a sharp 7.5-million-tonne jump in the estimate for Chinese output over the June estimate, to 105 million tonnes. China will not be a factor in world trade in this environment. Two years ago China ran a 10-million-tonne deficit and needed to import close to 7 million tonnes. This past season it purchased only 1.3 million tonnes, and whatever is imported during the new marketing year will be insignificant.

India, on the other hand, imported no wheat in recent

years, but is expected to purchase close to 5 million tonnes this year because of a poor crop of only 68 million tonnes, down from 2005-06 production of 72 million tonnes. The government has slashed import duties to 5% from 50%, a clear indication that supplies are low enough for the normally protectionist government to be feeling anxious about its ability to feed its constituents.

It has been a hot summer everywhere, though, and we can expect downward revisions to surface as more accurate estimates are released approaching harvest season.

The International Grain Council (IGC) has already weighed in with some estimates that seem to be more current and that reflect the effect weather conditions have had on some key global crops. On July 27 it released a report that lowered the Australian crop to 20 million tonnes from its previous estimate of 22 million tonnes and the USDA's 21.5-million-tonne forecast. Recent local estimates have been seen as low as 18 million tonnes. Australia is of particular importance. It is the world's second or third largest exporter (depending on the season), and if it falls short on available exportable supplies, an immediate tightness develops among its traditional Asian customers.

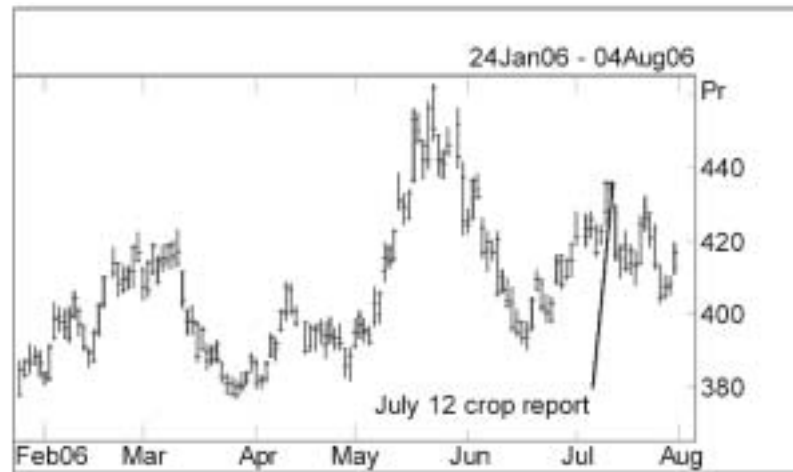
The weather has been uncooperative in Europe as well, and the IGC has made some adjustments. It has lopped 2 million tonnes off the French crop and 1 million tonnes from Turkey's output.

The July estimate for 2006-07 global ending stocks increased slightly, to 21.6% of consumption, compared with the June estimate of 20.8%, and still down from 23% at the end of 2005-06. Poor crop development in the regions discussed above are sure to bring inventories down a notch.

The USDA forecasts that US exports will continue to slump this year. Actually, it is looking at a rather steep drop to 24.5 million tonnes, down from 27.32 million tonnes last season and 28.92 million tonnes in 2004-05. After 2 months of the new marketing year, commitments are running 11.5% behind last year's pace, which is in line with the USDA forecast. This could change rapidly, however, if the Australian crop does not improve or if India buys more than anticipated.

The dip in price generated by the slightly bearish July data is nothing but a buying opportunity in this ongoing bull market. [August 1, 2006]

Chart 3 – December wheat



Courtesy Reuters

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