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Copper: about face

We've been bearish on copper for the longest time. The prices we've seen over the past few years are miles above the cost of production, which we reasoned would eventually result in mining companies overwhelming the market with supply. Even at \$2.40 per pound – the level the market plunged to this past February – copper mining would remain highly profitable, and there would be no motivation for production to be pared back (Chart 1). Surpluses would emerge even as demand continued to grow. And up until a few months ago, that's the way things were shaping up.

As recently as May 17, the International Copper Study Group (ICSG) estimated that the 2007 global balance sheet for copper would show a 280,000-tonne surplus. The projection for 2008 called for a surplus of 520,000 tonnes. The direction of the data that these forecasts were based on, however, has changed course.

After finishing 2005 with a deficit of 107,000 tonnes, the market swung sharply to a surplus of 361,000 tonnes by the end of 2006. There was little reason to think that the trend would be halted abruptly, but it was. By the end of the first quarter of 2007, the balance sheet had moved to a 143,000-tonne deficit.

Despite flat consumption in the US and Europe, total global demand grew by 9% in the first quarter, compared with the same period in 2006, because usage in China, India, and other emerging regions is booming. On the other hand, total refined production for the period grew by only 4%.

There's been a fair number of labor disputes in principal production regions, most notably in Chile. Sub-contract workers have been on strike for five weeks, which until a couple of days ago resulted in curtailed production at El Teniente, the world's largest underground copper mine. Over the past few days, the mine was brought to a complete standstill as violent protests broke out, which included the sabotage and derailment of a train carrying copper concentrate. At the time of this writing, a provisional agreement had been negotiated.

Despite the ongoing labor strife, Chilean mines were still able to crank out a very respectable average monthly production growth rate of 4.27% from January through June. But generally, output is lagging the torrid pace of consumption.

The most recent figure showed that June Chilean output was up only 1%, and it will be interesting to see what

the number looks like for July when the bulk of the strike took place.

The indicators that we follow present a mostly – but not completely – bullish picture. Global warehouse stocks (LME, COMEX, and Shanghai) peaked this past March at 280,000 tonnes and have declined steadily to their current level of 214,000 tonnes (Chart 2).

The cash-to-3-month spread at the LME has sprinted to a steep backwardation of \$152 per tonne, a level we haven't seen since early 2006 when the market was trading at its highs (Chart 3). COMEX prices remain in backwardation, but the inversion has been in a downtrend (Chart 4). Shanghai spreads have floated down to flat (Chart 5).

The past two weeks saw the US stock market score a record high followed by a dramatic plunge that was triggered by fears of the ripple effect that the sub-prime crisis could have on the broader economy. Industrial materials markets were affected – silver took a dive, the other base metals were weak. Copper participated as well, but has since recouped more than half its losses.

We certainly did not expect the turn in the balance sheet from surplus to deficit at this point in the economic cycle. We are impressed by market action and by copper's relative strength to the other base metals (Charts 6 and 7). We are therefore recommending initiating long positions, using the \$3.50-per-pound level, basis September, as a close only stop. [August 2, 2007]

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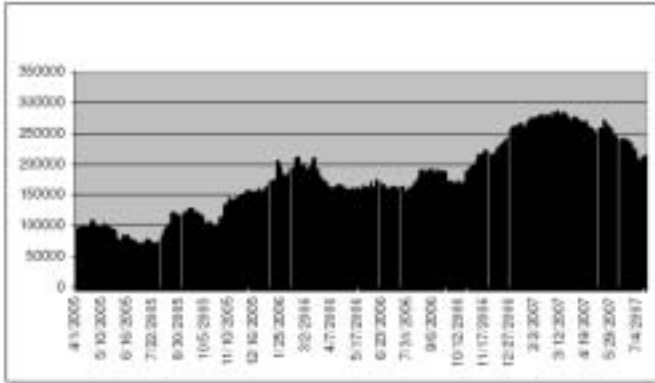
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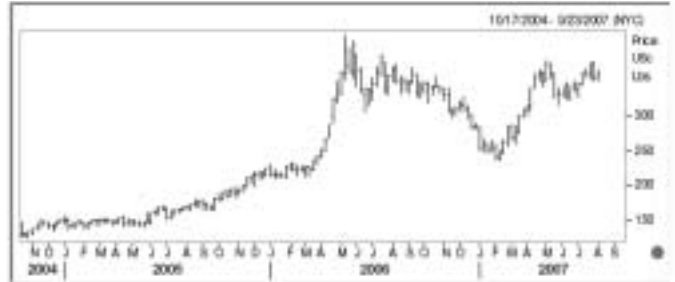
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Chart 1 – Global copper warehouse stocks (tonnes)



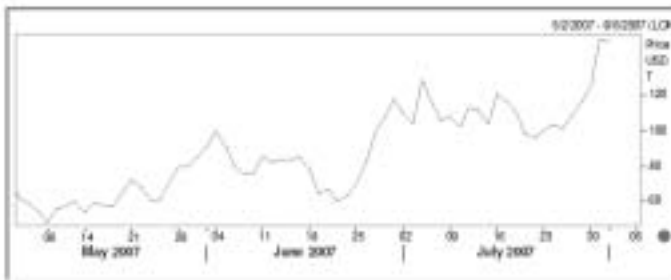
Source: Bloomberg LP

Chart 2 – Copper - Nearest contract



Source: Bloomberg LP

Chart 3 – Daily LME cash/3-month spread



Source: Bloomberg LP

Chart 4 – Daily Comex Sep/Dec spread

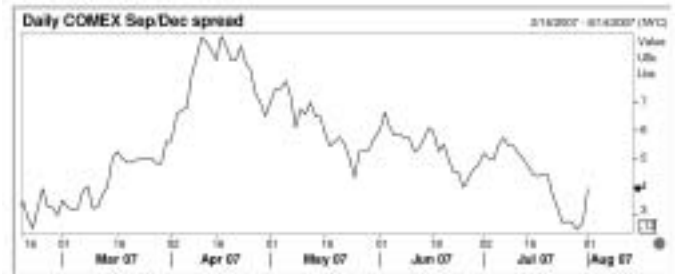
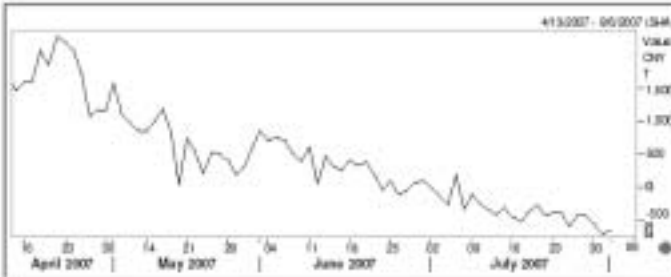


Chart 5 – Daily Shanghai Sep/Dec spread



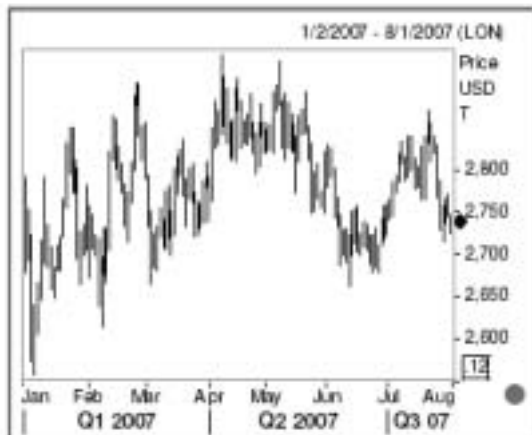
Source: Bloomberg LP

Chart 6 – Daily LME nickel



Source: Bloomberg LP

Chart 7 – Daily LME aluminum



Source: Bloomberg LP

COTTON

Lowest US acreage since 1989 threatens to tighten global supplies

The June 29 USDA acreage report for the 2007-08 US cotton crop that will be harvested this fall surprised the street and sent prices soaring to levels not seen since May 2004. Analysts were expecting farmers to continue shifting cotton to corn acres. The average guesstimate was 11.55 million acres, down from the March USDA estimate of 12.15 million acres, already dramatically lower than 2006-07 acreage of 15.274 million acres. The figure came in close to 500,000 acres below the guesstimate at 11.058 million acres, a staggering distance from last season's cotton acreage. In fact, the decline is a throwback to a totally different era – US cotton acreage has not been this small since 1989.

The news was greeted with a rally that took the market as high as 7¢ per pound above the close the night before the report was released (Chart 8). The market has since set back and has covered the gap that resulted from the unexpected results of the acreage report.

Obviously, the US crop cannot afford any weather surprises. There have been drought conditions throughout the various cotton regions spanning California right across to the Southeastern cotton states. At present the western part of the country is experiencing potentially harmful excessive precipitation, but the eastern regions are generally faring well.

Overall, though, the crop is not doing too badly. The most recent crop condition report showed that the good-to-excellent portion of the crop fell two percentage points since the previous report, to 54%, on account of recent developments. But this is still well above conditions at this time last year, when the good-to-excellent portion stood at only 39% of the total crop.

The USDA is trading conservatively with its yield estimate. In the July supply/demand situation report, the estimate was lowered from the 820-pound-per-acre June estimate to 800 pounds per acre, which is below the 2006-07 yield of 814 pounds per acre.

The drop in US output could have a major impact on global supplies, but it is not the disaster it seems to be on the surface. US exports were somewhat of a disappointment in 2006-07. Early forecasts called for US exports to reach about 16 million bales.

With July 31 marking the end of the 2006-07 marketing year for cotton, US exports just missed the more current estimate of 13 million bales. What this means is that

last year's near-record crop left over a much-larger-than-typical US carryover of 9.8 million bales, which will allow exporters to meet the needs of foreign purchasers – should they return. The USDA estimates that new crop exports will bounce back to 17 million bales. History shows that this is achievable because 2004-05 sales were 18 million bales at a time when the gap between Chinese production and consumption was 17.5 million bales, whereas that gap has now grown to 21.5 million bales.

Even after the Chinese crop was revised upwards in July by 1.5 million bales – to a record 32.5 million bales – the 2007-08 global balance sheet has tightened substantially. Ending stocks are forecast to fall to 50.78 million bales, or 40% of consumption, down from 2006-07 and 2005-06 stocks-to-consumption ratios of 46.8% and 49.6%, respectively.

While a carryout of 40% of usage may be considered burdensome for many commodities, it is not for the cotton market. Cotton prices rallied from under 30¢ per pound in late 2001 to over 80¢ per pound in mid-2003 with a stocks-to-consumption ratio that averaged 44.5% in 2002-03 and 2003-04. In 1993-94 ending stocks sank to 37.7% of consumption, and prices rocketed to \$1.15 per pound.

The potential hazard for bulls is that exports don't meet the USDA's forecast, just as they did not this past year. Otherwise, we view the current pullback as a countertrend correction. A drop in open interest has accompanied the drop in prices, which we view as a healthy shakeout (Chart 9). We recommend a long position in December cotton, using a 61.50 stop, close only.

[August 3, 2007]

Chart 8 & 9 – Chart 8 (bar) - Daily December cotton, Chart 9 (line) - Open interest



Source: Bloomberg LP

SUGAR

Ethanol demand grows, but sugar supply is not threatened

The bull market in sugar ended early in 2006. Prices have fallen by more than 50% from their 19.5¢-per-pound peak to their mid-June bottom of below 8.5¢. It may be meaningless anecdotal evidence, but the current rally began with a handsome, one-session pop of over half a cent on June 18, the very same day that crude oil prices broke above the range that they had been trading in for most of 2007 (Charts 10 and 11).

Traders are convinced that prices for any biofuel feedstock must rise when petroleum products becomes expensive because demand for biofuels will automatically increase and the ratio of the commodity that is used for food versus energy will shrink, which will in turn cause a scarcity of that commodity. The theory certainly has merit, but in the case of sugar it's simply not unfolding that way.

Although we too touted the idea that the bull market in sugar was closely tied to the growth of the ethanol market – and to some degree it was – the primary market mover turned out to be two consecutive disastrous crop seasons in India. India had to draw down its once huge inventories and even had to tap the import market.

The high prices that resulted, however, inspired a sugar frenzy among Indian farmers. After recovering back to normal levels in 2005-06, with a crop of 21 million tonnes, up from about 13 million tonnes in 2003-04 and 2004-05, Indian output will reach 28.5 million tonnes this season, according to a recent estimate. For 2007-08, which begins in October, analysts are talking about 30 million tonnes.

At the end of 2005-06, Indian ending stocks stood at less than 5 million tonnes. Estimates for 2007-08 are in the 15-million-tonne range, which includes forecasts for exports to grow to between 4 and 5 million tonnes, up from 2006-07 exports of just over 1 million tonnes. Serious competition is posed to traditional relationships between Asian importers and Brazil, Australia, and Thailand, particularly the former two because of the advantage of much shorter shipping routes.

As far as Brazil is concerned, ethanol-related developments are as bullish as can be, but they are not moving the market. On July 1, the government increased the minimum requirement for ethanol again, to 25%, from 23%. To accommodate the increase in usage, E.D. & F. Man estimates that the amount of cane dedicated for ethanol in Brazil for the 2007-08 marketing year will rise to a ratio of 54/46 favoring ethanol over food.

Viewed in isolation, the Brazilian situation would seem to be very bullish for sugar prices. Between exports and domestic consumption, all the cane crushed for sugar is consumed, which leaves no carryover stocks. The Indian surplus, however, should be able to absorb any increase in world demand.

On August 3, Switzerland-based sugar analyst Kingsman increased its estimate for the 2007-08 global surplus to 11.16 million tonnes, up from its previous estimate of 9.48 million tonnes.

The sugar market is as well supplied now as it has been at any time in memory. The market has tested the 10.5¢ per pound level several times but is drawn back into the recent trading range. We believe that the market remains overpriced and will resume its downtrend – sooner or later. By the same token, sugar is a commodity fund favorite and could easily be run up as traders neglect the underlying supply/demand fundamentals and focus on short-term technical chart patterns. Indeed the market has been rallying for a couple of months and the chart can be considered bullish. We are therefore recommending a short position, but with a very conservative stop of a close above 10.6¢, basis October.

[August 3, 2007]

Chart 10 - Daily October sugar (bottom),
Chart 11 - Daily September crude oil (top)



Source: Bloomberg LP

CORN

Has anyone seen the bull?

Corn prices have now fallen by as much as \$1 per bushel from their early-June highs – a drop of 25%. We're supposed to be in a bull market.

The slide in prices was primarily the result of the huge increase in US corn acreage. US farmers responded to the prospects of having the ethanol market take an ever-increasing portion of the US corn crop away from the feed market. The outcome was extraordinary. US corn acreage for the 2006-07 season was 78.327 million acres. The March planting intentions report pegged 2007-08 acreage at 90.454 million acres, already a stunning increase from the previous season. The average of analysts' guesstimates heading into the June 29 report was for a slight increase to the March estimate, to 90.618 million acres, but they were off the mark by a wide margin. The actual number was 92.888 million acres, a modern-day record by far.

At the time of the report, most of the selling had already taken place. The market did make new lows, but then rallied to pre-report levels before selling off to yet another series of new lows. Prices have now consolidated (Chart 12).

The USDA is using a fairly optimistic 150.3-bushel-per-acre yield estimate, up from 149.1 bushels per acre last season, which would mean a record harvest of 12.84 billion bushels (326 million tonnes), compared with last year's output of 10.535 billion bushels (267.6 million tonnes). Some analysts argue that it is not realistic to expect optimum yields, because a good part of the increased acreage was planted on land with poor-quality soil.

The past few days saw two estimates released for the new US crop by headline-grabbing private forecasters, but it served only to confuse the matter further. F.C. Stone came in with an estimate of 12.644 billion bushels (320 million tonnes), while Informa put the crop at 13.09 billion bushels (330 million tonnes).

It's been particularly frustrating for bulls, because US exports were very strong in July, but the market barely noticed. Commitments in July averaged 1.438 million tonnes per week (new-crop plus old-crop). While this is a very robust pace, it is not unprecedented. Last July, average weekly net new sales were 1.053 million tonnes, but they picked up in August to 2.065 million tonnes.

Another bullish factor is the surprisingly poor Northern Hemisphere wheat crops. The wheat/corn ratio has skyrocketed to record highs (Chart 13), and one can be sure that wherever choice exists, corn will be the carbohydrate feed of choice.

We've argued in the past that the USDA was overly exuberant with regard to its ethanol consumption forecasts, because the monthly data showed that the ethanol usage rate was not growing at a fast enough pace to meet the USDA's 2.15-billion-bushel estimate (54.6 million tonnes). But the numbers have caught up over the past couple of months, making the 3.4-billion-bushel (86 million tonnes) estimate for 2007-08 seem somewhat more attainable – if the current growth rate continues.

The increased US acreage was an absolute must. To get an idea of just how tight the 2007-08 balance sheet would have been had the trip to over \$4 per bushel not inspired corn farmers to plant so many acres, consider the difference between the June USDA balance sheet, which used the March planting intentions to calculate the US crop, and the July revisions, which included the June 29 acreage report. In June global ending stocks were 91 million tonnes, or 12% of consumption, the lowest level since the early 1970s. The jump in the forecast for the US crop of 10 million tonnes pushed the stocks-to-consumption ratio up to 14%. This is still very low in historical terms. This season should finish at about 14%, down from 17% in 2005-06.

The market has broken away from the recent lows as crop conditions in the US deteriorated. The most recent report showed the good-to-excellent portion at 56%, down from 58% the previous week and from 74% in early July.

While everything pretty much looks bullish about this market, we continue to have no strong opinion about the next major move. After all, corn prices are very high in historical terms, and it is very likely that the efficient market is in a process of addressing the looming drastic spike in demand that will be caused by the growth of the ethanol market. We prefer to remain sidelined, particularly at this time of the year, when the volatility can be so great because of day-to-day weather changes.

[August 8, 2007]

