

# FRIEDBERG'S

## FOCUS ON FUTURES

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## Cotton output rebounds. Is it enough?

Old-crop cotton prices have been trading at two-year highs over the past few months (Chart 1). To understand how global inventories of an industrial commodity could be tight enough to justify such high prices just as the world slowly emerges from a deep world-wide recession, consider some recent history.

After stopping just short of the \$1-per-pound mark early in 2008, the market collapsed and could not find any support until the 40¢-per-pound level. Although prices of other commodities were also falling during the same period, it was still more profitable to plant those alternative crops, such as soybeans. Cotton output in all key producing regions plunged as a result.

US production in 2008-09 and 2009-10 was about 35% below 2007-08 output. In addition, forecasts for cotton consumption were viewed in terms of how demand for industrial commodities would fare in a recession, which did not provide much of an incentive to plant cotton where more lucrative crops could be substituted.

Then, everything that could go wrong did. The crops that were planted on reduced acreage suffered from inclement weather, in both the US and in China. And to complicate matters, global demand was underestimated. Early projections for the now-almost-complete 2009-10 marketing year called for a global production/consumption deficit of 7 million bales, but recent data show that the deficit has ballooned to 14 million bales. The earlier estimate would have amounted to a carryover of 50.8% of consumption, down from 56.5% in 2008-09. But the latest figures leave 2009-10 ending stocks at 43.7%, which is the lowest carryout since the mid 1990s, when prices rocketed to \$1.15 per pound.

While that explains why cotton has been one of the few commodity markets to see prices storm back to challenge 2007 price levels, is the momentum sustainable?

New crop area is up. Planting and growing conditions have been mostly favorable. The market has backed off sharply since mid-June, while 2010-11 crops develop without any major problems.

At one point it was believed that Chinese area would be below last year's, but a recent USDA attaché report indicates that cotton acreage would be about equal to last season. This means that with normal weather conditions, the crop will be larger than last year's poor-weather-plagued crop.

The June 30 USDA acreage estimate showed that US farmers planted 10.909 million acres for the 2010-11 crop, 440,000 acres above the March intentions estimate, and slightly higher than trade estimates. In the July 9 monthly crop report, the yield estimate was raised as well, by 30 pounds per acre, to 845 ppa. This put the US crop forecast at 18.03 million bales, just over 300,000 bales above trade guesstimates – a major recovery from the 2009-10 multi-decade low output of 12.19 million bales.

Global production for 2010-11 is expected to jump by 13.5 million bales, or 13%, over 2009-10 output. But despite the robust increase in output, stocks will continue to be drawn down as demand grows. Ending stocks are estimated at 50 million bales, or 41.6% of consumption.

The price of December new-crop cotton has tumbled by about 10% from its mid-June peak (Chart 2) which is well warranted, in terms of the size and progress of the developing crops in both the US and China. Long-term trends have corrections.

If there was a speculative bubble, it has been tempered. Chart 3 shows that the fund net-long position rose with the market, but that there has been substantial liquidation.

Despite the jump in output, however, global inventories continue to fall, as amply illustrated above.

We recommend using this dip as a buying opportunity.

[July 14, 2010]

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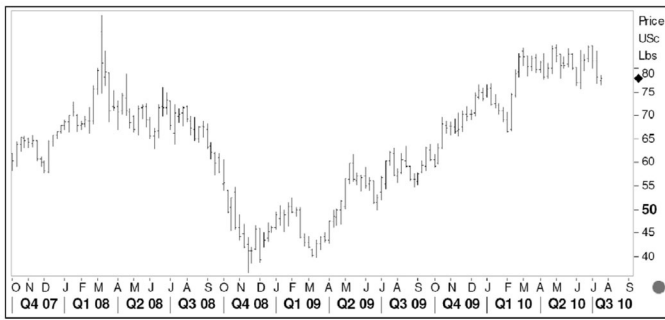
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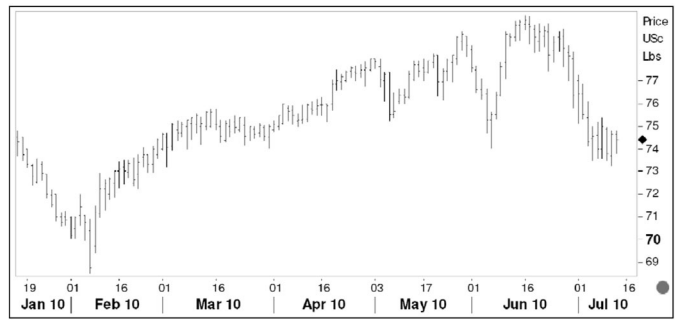
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Chart 1 – Nearest contract weekly cotton



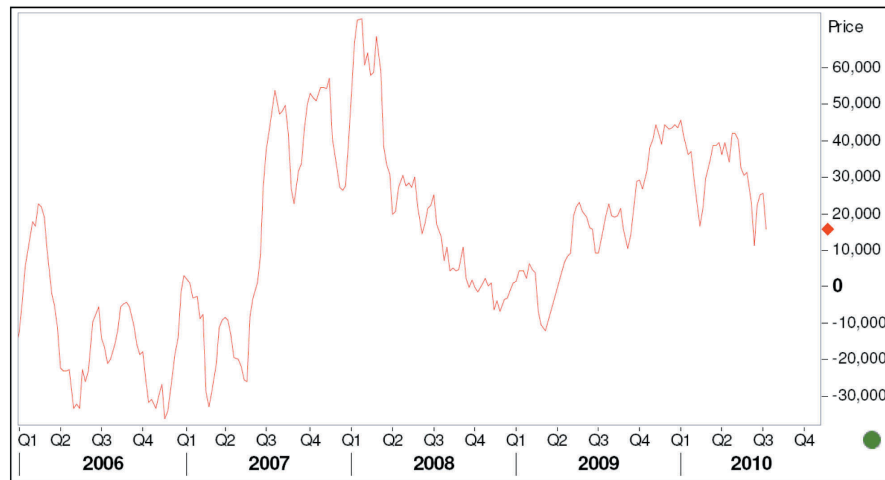
Courtesy Reuters

Chart 2 – December cotton



Courtesy Reuters

Chart 3 – Fund net-long position



Courtesy Reuters

## **COPPER**

### **A 360 for the copper balance sheet**

When we last discussed the copper market on May 28, we were definitely bearish. Having been stopped out of our short position near the April highs, we were reluctant to re-establish a short position after the market had quickly tumbled by about 10% from its peak (Chart 4). At the time, prices were consolidating between \$3 and \$3.20 per pound, and we suggested exercising a bit of patience in trying to sell the market on a bit of a rally to the \$3.25-to-\$3.30-per-pound level. Prices fell further, but have now climbed back to just shy of our target sell zone. Now that it's within reach, do we still want that short position?

Since 2002, copper prices have mapped out a course

that has tracked the general direction of the stock market. The US stock market fell sharply in June, retreating to 10-month lows. Copper prices fell alongside June's 9% slide in equities. Recent developments in copper's supply/demand fundamentals, however, saw copper outperform stocks and kept copper from challenging its early-June lows (Chart 5).

On April 30 The International Copper Study Group (ICSG) forecast that the global supply/demand balance would end 2010 with a 580,000-tonne surplus, compared with a 365,000-tonne surplus in 2009. In its monthly report released on May 20, which covered January and February, the surplus stood at 148,000 tonnes and well on its way to

meeting the target for 2010.

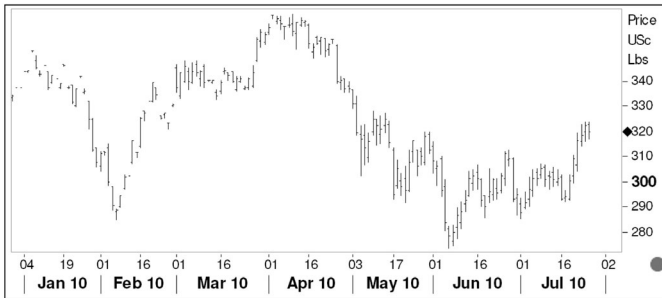
So it was quite a surprise when the June 22 report showed that for the first quarter, the global balance had slipped into a small deficit. One month later, the balance sheet swung completely the other way – the January-/through-April period posted a 67,000-tonne deficit.

The turnaround is on account of improved demand. Early in the year global consumption of refined copper was growing by 5.9% over the same period in 2009, with refined production increasing 5.8%. According to ICSG's most recent report, production is still growing by 5.8%, but usage is accelerating by 8.3%.

China compensated for poor demand in the industrialized world during the worst of the recession by gobbling up foreign copper supplies at a rapid pace. ICSG reports that consumption is now being fueled by Japan, the EU, and the US.

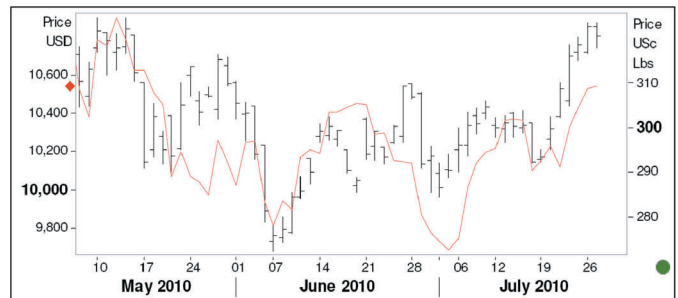
For that matter, Chinese implied demand is estimated to have fallen by 2.8% over 2009. Imports peaked in mid-2009. Strong purchases in March and April have turned out to be a flash in the pan. The most recent data show that June imports were down 24% over May and 44% below last June (Chart 6).

Chart 4 – September copper



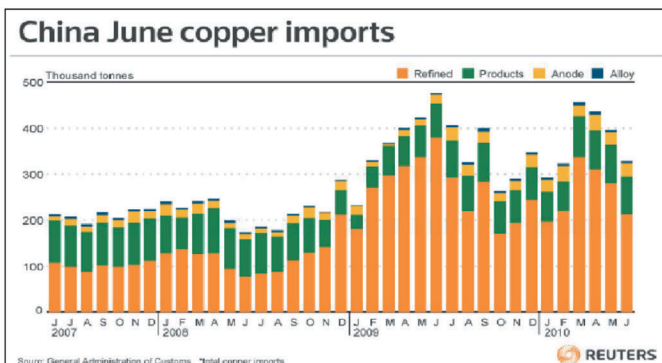
Courtesy Reuters

Chart 5 – Nearest contract copper (bar), DJIA (line)



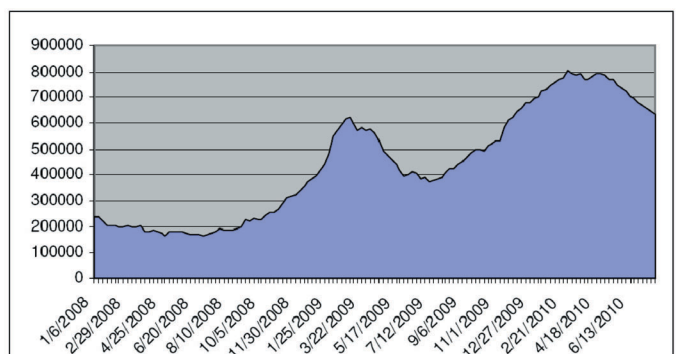
Courtesy Reuters

Chart 6 – Chinese copper imports



Courtesy Reuters

Chart 7 – Global warehouse stocks



Courtesy Reuters

Production, on the other hand, has slowed in the US, Indonesia, Peru, and Australia, falling 7.5% in ICSG's study period. Even in Chile, where output has been growing by 3.7% this year, output was down by 5.4% year-over-year in most-recently-reported May.

The effect of growing demand and flat production has shown up clearly in warehouse data. Chart 7 shows that combined inventories at the LME, COMEX, and Shanghai warehouses peaked in February and have since shed about 150,000 tonnes, or 19%.

In the grand scheme, copper prices are still trading at many times the average global cost of production, so it's hard to get worked up into a bullish frenzy. The slow-down in output could be temporary – copper mining remains a very profitable business. The pickup in demand is subject to the strength and duration of the global economic recovery.

Nevertheless, our recommendation to sell copper short at just above current levels has gone stale, because it was issued considering a different set of circumstances. We rescind the recommendation and advise remaining on the sidelines at present. *[July 28, 2010]*

**WHEAT****Drought in Europe sends wheat prices flying**

US farmers planted 5 million fewer acres of wheat for 2010-11 crops than they did a year earlier, but output is expected to match 2009-10 production nonetheless. This was possible because of the excellent results seen for both the nearly-completely-harvested winter wheat crop and for the developing spring wheat crop. The harvested-to-planted ratio is estimated at 88.9%, compared with 84.4% in 2009-10. Then the July crop report revised upwards the average yield by 4.55%, to a record 45.9 bushels per acre. The spring wheat crop progress report shows that 82% of the crop is in good-to-excellent condition, up from only 71% at this time last season.

After several years of strong increases in global wheat output since mid-decade, inventories were being replenished. Carryover stocks for the recently completed 2009-10 marketing year are estimated by the USDA to have grown to 29.6% of usage, after dipping to as low as 20% at the end of 2007-08. Early forecasts for the new marketing year had stocks slipping a bit because of flat production and a jump in output, but as recently as June, global ending stocks were still estimated to be a very comfortable 29.05% of consumption.

Weather problems in other major producing/exporting nations, however, are offsetting the cheerful outlook for the US. Even before the full extent of the damage was factored into the balance sheet, the July crop report lowered the estimate for global ending stocks to 187 million tonnes, 6 million tonnes below the June estimate, or 28% of usage. Canadian and FSU output were lowered by 4 million tonnes and 7.5 million tonnes, respectively. EU production was only revised lower by just over 1 million tonnes, which obviously did not reflect more recent developments.

Extreme drought conditions in Russia, the worst in many decades, persist. Some estimates have the crop falling to 49 million tonnes, 4 million tonnes below the USDA's already-lowered July forecast, and about 13 million tonnes less than 2009-10 output of 61.7 million tonnes. There is concern that Russia is on the verge of banning wheat exports altogether to protect domestic prices from spiraling out of control. Furthermore, drought in the

affected areas is so severe that there are fears that subsoil moisture for planting 2011-12 winter wheat crops in the autumn cannot be restored in time.

The Ukraine is experiencing drought as well, with wheat crop losses expected to be about 10%, down to 18 million tonnes. Although not as important as the Russian crop, the portion of the crop that will be of milling-grade food quality will be only about 30%, much lower than the historical norm.

The USDA July estimates for the EU did not seem to catch much of the crop damage. Estimates are all over the place, but a conservative average would be a further downward revision of about 8 million tonnes.

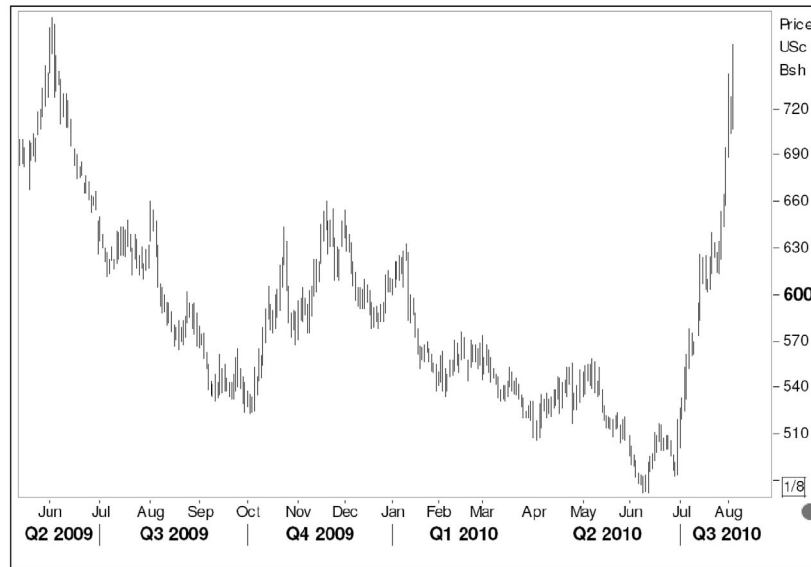
Putting it all together, the bulk of crop losses in Europe and Russia have not been accounted for in the USDA's July crop report. We should see ending stocks revised downwards by about 15 million tonnes, to 172 million tonnes. If the USDA does not change its estimate for global consumption, we are looking at a drop in inventories to 25.7% of usage. At that level it is still hard to envision shortages.

Just about every analyst is downplaying the significance of the crop losses, intimating that this massive rally is overdone and not a true reflection of the supply/demand fundamentals. They found support in recent crop upgrades for Australia and India. Indeed, despite the severity of the sudden supply losses, the years of plenty have at least left the market in a position of strength to deal with this crisis.

It will probably take some time to get a clear picture of how the European weather calamity will impact the bottom line. In the interim, the key issue to monitor is whether Russia will honor export commitments. If it does not, the comfortable level of US ending stocks is likely to be drawn down rather quickly, which renders the high level of global inventories a relatively insignificant statistic. The inventory totals consist of bits and pieces. No single country, or even group of countries, can replace the loss of Russian exports.

We missed this train. If there's a pullback, stand ready to board. *[August 5, 2010]*

Chart 8 – December wheat



Courtesy Reuters

## CORN

### In the shadows of wheat?

For grain market participants, all eyes have been on the wheat market. Prices spiked because of a devastating drought across the major wheat regions of the EU and FSU. It is assumed by many that the accompanying, small-by-comparison, rally in corn is strictly a copycat move. Clearly, the magnitude of the supply problems plaguing the wheat market are unique to the wheat market. But, aside from the strong direct and logical connection between corn and wheat (in terms of corn being a carbohydrate substitute for anticipated depleted feed wheat supplies – and a cheap one at that, with the way wheat prices have popped), we believe that the supply/demand fundamentals for corn are independently bullish.

Initial reports regarding the first Chinese corn imports in four years, and the largest since 1995, stirred some bullish interest for corn in early May, but the market soon resumed its downtrend and proceeded to make new lows for the year. The pace of US sales to China has remained steady, though. In July, the Chinese committed to purchases of an additional 300,000 tonnes of US corn, for a year-to-date total of 1.2 million tonnes. About half of the purchases have already been shipped. Analysts estimate that the Chinese could import up to 10 million tonnes of old-

crop corn from all sources before their own crop is harvested in the fall.

Secrecy surrounding state-controlled commodity inventories in China keeps analysts in the dark. Corn areas in China experienced drought during the 2009-10 growing season. The USDA, which uses Chinese government data, still has the crop estimated at a just-below-average 155 million tonnes. It is unlikely that this figure is accurate.

While the government can conceal inventory levels, it is no secret that the drought was severe enough to limit yields. The hard evidence comes in the form of Chinese imports. Some private Chinese analysts say that the Chinese 2009-10 crop was no larger than 140 million tonnes. If this were true, then global carryover stocks on the USDA balance sheet should be reduced by 15 million tonnes, which would leave 2010-11 ending stocks at 126 million tonnes, or 15.16% of consumption, instead of the current estimate of 141 million tonnes, or 16.96% of consumption. That would be significantly below 2008-09 inventories that reached 18.82% of consumption, and right back to the 2007-08 level of 16.82% of usage that facilitated the 2008 bull market, when prices spiraled out of control, to \$7 per bushel.

If China does indeed become a more regular buyer of foreign corn, it will of course have to turn to the US. No other major producer has exportable surpluses that would meet the kind of volumes that China would need to feed growing animal populations. Since all the attention in the grain markets has been devoted to wheat, there has been little talk about what impact, if any, there would be on European corn crops. Europe is not much of a player in corn, but the Ukraine exports close to half its crop, which makes it the largest non-Western Hemisphere exporter. Private analysts have indicated that the crop was definitely affected by the drought. The USDA July estimate was 13 million tonnes, which will almost certainly be revised downwards. The Ukrainians will still be able to meet export commitments, but it will make things interesting.

The US should have ample supplies to meet export demand, should it arise. The crop is in fine shape, with the good-to-excellent portion of the crop at 71%, up from 68% last year at this time.

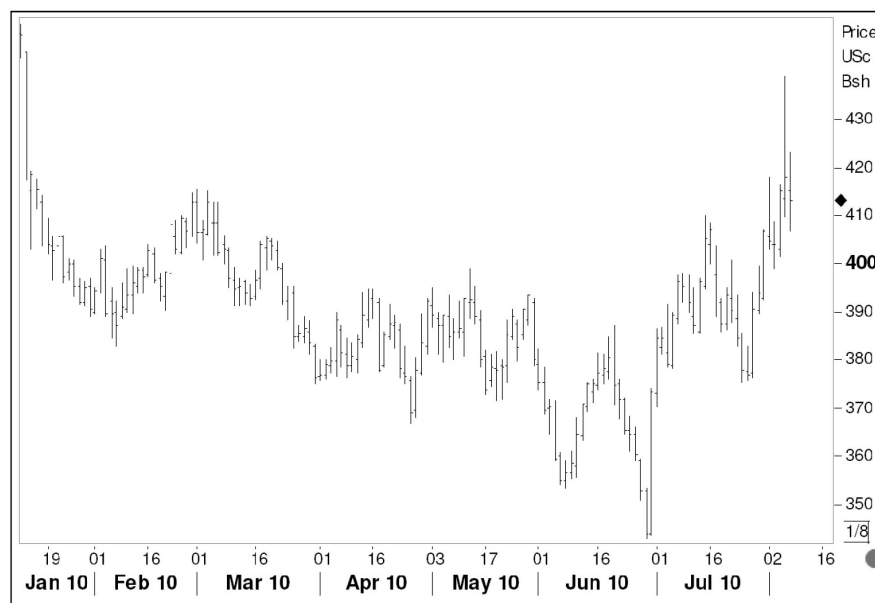
The USDA's July crop report incorporated the bullish June 30 acreage and quarterly ending stocks reports by lowering 2010-11 ending stocks to 34.89 million tonnes, or 10.27% of consumption, down from the June estimate of 11.73%. That's down from last season's 11.1% and off sharply from 13.87% in 2008-09.

We reiterate the point we've been harping on: As illustrated, there has been no progress in actually increasing the world's inventories to deal with expanding ethanol demand and the ever-present risk of crop failures.

Remain long.

[August 6, 2010]

Chart 9 – December corn



Courtesy Reuters

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