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Cocoa: not bad for bearish fundamentals

West African 2010-11 mid-crop harvests are winding down, and the output estimates are at record or near-record levels. Ghanaian production is now estimated at 1 million tonnes, far exceeding the previous record of 740,000 tonnes set in 2005-06. Ivorian port arrivals stand at 1.41 million tonnes, a record for this point of the season. Output in up-and-coming producer Cameroon shot up to 236,000 tonnes, beating the previous record of 210,000 set in 2008-09.

On August 26, to reflect these robust estimates, the International Cocoa Organization (ICCO) bumped up its estimate for the 2010-11 global surplus to 325,000 tonnes. That's up from its previous forecast for a surplus of 187,000 tonnes and a dramatic shift from the 125,000-tonne *deficit* recorded for the 2009-10 marketing year. With ending stocks at 1.93 million tonnes, the stocks-to-consumption ratio jumps to 50.4% of usage, up from 43.4% at the end of 2009-10. Not a terribly bullish scenario.

There have been two bullish developments over the past couple of months. Aging plantations and disease are a problem in most cocoa regions around the globe, but the effects have not been as severe anywhere as they've been in Indonesia. Output estimates for the current season have fallen to as low as 400,000 tonnes, compared with 530,000 tonnes in the previous season. It would seem that the forecast for such a large global surplus may not yet have accounted for the steep drop in Indonesian production.

Second-quarter cocoa grind statistics for non-origin countries were very strong. Europe was up 8.3% year-over-year. North American grind activity increased by 6.2%. Although these figures were above analysts' expectations, it is very likely that they were so strong only because European and North American processors were merely compensating for capacity lost temporarily during the standoff in the Ivory Coast. As such, it will be very interesting to see how third-quarter results – the period after the Ivory Coast got back on its feet – will turn out. That data will not be released until mid-October.

Studying fluctuations in butter/bean ratio values to determine whether grinding is profitable may have become somewhat archaic. Whatever significant growth there is in chocolate consumption is to be found in developing countries, which generally use a much higher ratio of powder to

butter in manufacturing chocolate. Chart 1 shows a powerful surge in powder prices over the past few years. More significantly, Chart 2 shows that, although butter prices have languished, powder prices have compensated. The combined price of butter and powder has gained steadily over the price of beans since mid-2010.

The advent of the powder market has been supporting demand and helps to decipher – at least in part – the enigma of how cocoa prices remain steady at multi-decade highs.

It is, we believe, highly unlikely that crops in Ghana shot up by such a wide margin in such a short period of time, while at the same time, neighboring Ivory Coast was able to crank out a bumper crop despite the fact that the industry was virtually shuttered for months during the main-crop season.

A plausible explanation is that smuggled beans were double counted. Smuggled beans usually move from Ghana to the Ivory Coast to take advantage of higher prices, but went the opposite direction this year, as Ivorian farmers became frustrated by earning no income at all.

The Ivory Coast data are somewhat more believable, because it has produced crops of similar size in the past and the arrival data published by the government matches – more or less – the parallel figures provided by exporters. Ghana has never produced anywhere near the amount of beans the official agency Cocobod is reporting, and there is less transparency, as we don't see the weekly numbers provided by

Inside

Cotton: US crop diverts the bear	2
Corn: Demand finally rationed?	4
Wheat: Waning demand for US wheat	5

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

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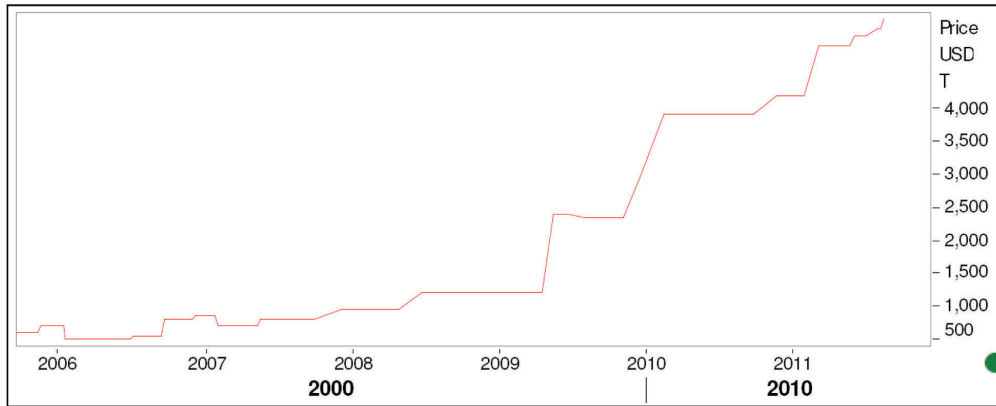
exporters to the government. Aside from musings in press reports, there is no evidence to corroborate this theory. Time will tell.

As a result of our skepticism, we question forecasts that call for such a healthy surplus. As well, it's hard not be

impressed with the action of a market that has been generating nothing but apparent bearish news.

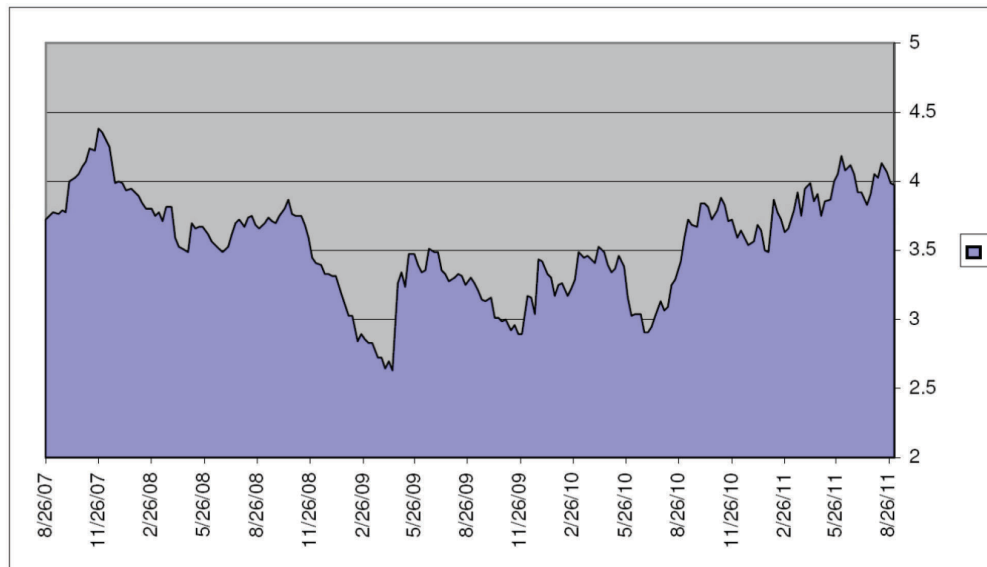
We're a bit offside on our June 29 recommendation to establish long positions. Place stops at \$2,800, basis nearest contract, close only. *[August 30, 2011]*

Chart 1 – Cocoa powder (dollars per tonne)



Courtesy Reuters

Chart 2 – Cocoa powder/butter ratio



COTTON

US crop diverts the bear

The global farmer had the best of intentions in trying to squelch runaway cotton prices. Acreage estimates expanded while prices zoomed out of control to more than \$2 per pound. In the US, planted cotton area for the 2011-12 crop to be harvested this autumn jumped to 13.73 million acres, up from 10.97 million acres in 2010-11. That's the largest area since 2006. Most other major cotton producer/con-

sumer nations, including China, India, and Pakistan increased acreage as well.

In the US it was all for naught, as it turns out. Weather has been poor. The USDA August crop report estimates that the harvested-to-planted ratio will be a paltry 70.4%. That is by far the lowest ratio in modern history. In good years that ratio reaches well more than 95%. The lowest

ratio in the past 25 years has been 80%, and it's only been that low several times. That puts the crop at only 16.6 million bales, down from 18 million bales in 2010-11. Very disappointing when you consider the 25% increase in planted area.

Some analysts have questioned the feasibility of the USDA's optimistic upward revision for yield in the August crop report to 822 pounds per acre, up from 800 pounds in July. That would be the best yield since 2007. Given the inclement planting and growing conditions, it seems unlikely that we could top the 2010-11 yield of 812 pounds per acre. Texas, the largest producing state, suffered its worst drought in a century. Some analysts put the yield as low as 700 pounds per acre. The most recent weekly crop progress estimates the good-to-excellent portion of the crop at 28%, down two percentage points from the previous week, and compared with 60% last year at this time!

The USDA's August global output estimate for 2011-12 was 122.71 million bales, up from 114.59 million bales in 2010-11, a 7% jump. Consumption is forecast to grow by a modest 1%. Ending stocks will jump to 52.66 million bales, or 45.7% of usage. That's very close to bear market territory. In 2009-10 and 2010-11 ending stocks fell to 37.4% and 39.5%, respectively. In the five years prior to that period, global ending stocks averaged 52.5% of usage.

We expect further downward revisions to the US crop. There has been some damage to the Pakistani crop from severe flooding. Other than that, the crops of the large producers should come in at expected levels.

That's the supply side. It's been months since the US

has sold much old-crop cotton. Starting way back in March, weekly net sales for old-crop cotton were negative in almost every reporting period. However, it was not nearly the bearish demand outlook that headlines made it out to be as business shifted to the new crop. New crop sales during this period were consistent with last year's level. As of September 1, 2011-12 commitments stood at 6.74 million bales, compared with 6.94 million bales last year at this time.

Prices have fallen dramatically from their peaks. Even new-crop December, which never made it past \$1.40 per pound (compared with old-crop spot prices, which traded well more than \$2.00 per pound), fell by some 35% to reflect deteriorating bullish fundamentals. These included the larger crops and soft demand. If export demand continues to chug along at a boring pace, then the increased availability from Asian countries may do the trick and bring prices back into historical ranges.

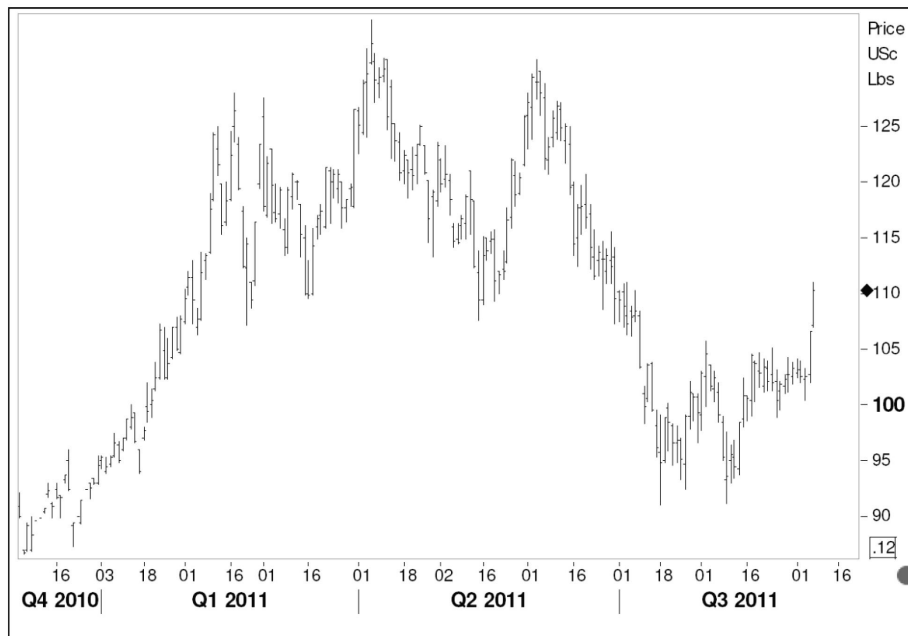
The US is the world's largest exporter, however, and supplier of last resort. Clearly, the market did not count on such devastating results from the 2011-12 crop. If we fall back into recession and demand levels are commensurate with economic activity, then the market caught a break and will be sufficiently supplied even with a small US crop.

Global ending stocks are just a chip shot from either bear- or bull-market territory. The crop failure in the US has ensured that the bear market has at the very least been delayed. If demand stabilizes and begins to grow again, we would expect prices to return to their highs.

Buy March cotton.

[September 9, 2011]

Chart 3 – March cotton



Courtesy Reuters

CORN**Have record prices finally rationed demand?**

Recessionary fears abound, and the bull markets in many commodities are unraveling. Corn has been an exception, even among US agricultural products, by exceeding the 2008 highs.

It's not a mystery. No other commodity has had to deal with sharing a new and growing source of demand: ethanol. US farmers responded to high prices by planting 92.3 million acres of corn, 4.1 million acres more than in 2010-11, but poor weather compromised their efforts.

The much anticipated September USDA crop report is now behind us, and the supply-side estimates showed mixed results. The USDA slashed the yield estimate from the August estimate by a staggering 4.7 bushels per acre (bpa), to 148.1 2 bpa. A downward revision was in the market, but the estimate was below the average analysts' guesstimate of 149.086 bpa. The crop estimate fell to 12.497 billion bushels, a scant 50 million bushels larger than the 2010-11 crop, which was planted on much smaller acreage.

On the other hand, the USDA maintained the August estimate for the harvested-to-planted ratio at 91.4%. Analysts were expecting to see the ratio lowered as well and were surprised that it was not. There is talk that once all the data are in, it will be reflected in the October estimate and that the cut could be as large as 1 million acres. That would bring the ratio down to 90.4%. Aside from the two disastrous crops in 2002-03 and 1993-94, that would be near the low end of the range of the past 20 years. Were that to happen, the crop would be 12.351 billion bushels – actually smaller than last year's crop!

The demand side of the report, however, mitigated the bullish implications of the shrinking crop. The USDA cut its forecast for all major demand categories from the August estimate. Domestic feed was lowered by 200 million bushels, and ethanol usage and exports were revised downwards by 100 million bushels each. The 400-million-bushel drop in demand was equal roughly to the decrease in the crop estimate. The estimate for ending stocks fell from 5.4% of consumption in August, to 5.2%, the lowest level since 1995-96.

The report was deemed bearish by analysts in the pre-market of the trading session following the report, and as a result, the market opened lower. However, reports that dropping temperatures had put crops in some areas at risk of frost rallied the market. December corn closed up 9¢ per bushel.

Despite the overwhelmingly disappointing crop, we have tempered our bullishness.

First, although the bpa yield was lower than expected, it was widely expected to be much worse than the August estimate, and in fact, it was in the middle of the range of expectations. Some guesstimates were as low as 143 bpa. So it was not really news at all and probably was already built

into the market. The real surprise in the report was not the supply side, but rather the bearish demand side.

The USDA is forecasting a 10% drop in US exports for 2011-12, but commitments to date are 13.5% behind last year's pace. It's very early in the marketing year, but the rationing process may be working, and it's entirely possible that we won't see sales pick up at these prices.

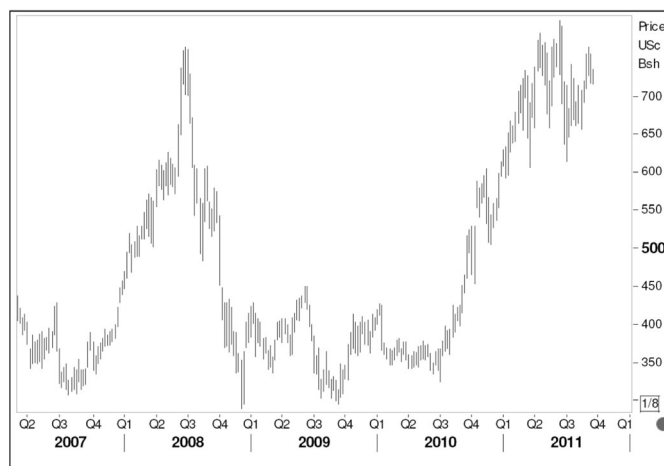
Then, the US is still by far the world's largest corn producer and will be for years to come. But its position of supplier of last resort will not be quite as prominent as it has always been. South American corn-producing nations are expanding their corn acreage. The USDA raised its estimates for Brazilian and Argentinean crops to be harvested early in 2012. The Brazilian crop is forecast at a record 61 million tonnes, up from 57.5 million tonnes in 2010-11, while Argentinean output will increase from 22 million tonnes in 2010-11, to 27.5 million tonnes. Still dwarfed by US production of 317.44 million tonnes, but enough to tip the global balance sheet and add to the pool of supplies available for world trade.

Global ending stocks were revised upwards in the September crop report, to 13.6% of usage, from the August estimate of 13.2%. That's still near historic lows. But with the outlook for soft global demand, we can see that number inch higher to represent a comfortable global inventory level.

We remain sidelined for now to see how the frost scare will play out. However, once the harvest is well underway, we envision trading this market from the short side. Stay tuned.

[September 13, 2011]

Chart 4 – Weekly corn, nearest contract



Courtesy Reuters

WHEAT

Foreign demand for US wheat wanes

According to the USDA's September crop report, global wheat production for 2011-12 is estimated to have grown by 30 million tonnes, or 4.6%, over the previous season. Ending stocks were revised upwards, from 28% of usage to 28.7%, but will still be down from last year's 29.5% of usage, because consumption is estimated to grow substantially as well.

The largest single factor in the close-to-\$5-per-bushel rally in the wheat market, which lasted from July 2010 to early-2011(Chart 5), was the crop failure in the FSU. Output in the region for the 2010-11 marketing year fell by a glaring 29% from 2009-10, to 81 million tonnes.

Northern Hemisphere 2011-12 winter wheat crops have now been harvested, and it seems that production has recovered. Total output for major exporters Russia, Ukraine, and Kazakhstan is estimated to have bounced back to 107.45 million tonnes. Exports are expected to more than double from 14.61 million tonnes in 2010-11, to 33.21 million tonnes.

Excessive precipitation during the harvest in late August and early September, however, has compromised the rosy outlook for both FSU and EU wheat crops. At one point earlier in the season it was believed that Ukrainian wheat output would improve not only in size but in quality as well. The agriculture ministry had forecast that 70% of the crop would be milling quality, food-grade wheat. Earlier this month, it retreated on that estimate, saying that only 40% to 45% of the crop would be food-grade.

The effect on the EU crop was not as dramatic, but estimates have been lowered, for both size and quality.

Quality concerns are also an issue in the US. As it is, the crop is 4 million tonnes, or 6.6%, smaller than last year. Charts 6 and 7 show that the price of new-crop Minneapolis Grain Exchange wheat, which represents the highest quality in the US, has gained substantially over Chicago Board of Trade and Kansas City Board of Trade prices.

Normally, the quality concerns in these major export-

ing countries would be causing a bit of a stir, but wheat prices have been trending lower since late August, particularly with the USDA's forecast for record global demand.

In its September crop report, the USDA cut its estimate for 2011-12 US exports by 2 million tonnes, to 27.9 million tonnes. That would be 20% below 2010-11 exports. Export commitments to date stand at just over 13 million tonnes, only 15% below last year at this time. However, given the very slow pace of new sales over the past couple of months, it's only a matter of time before commitment data more accurately reflect the USDA forecast for 2011-12.

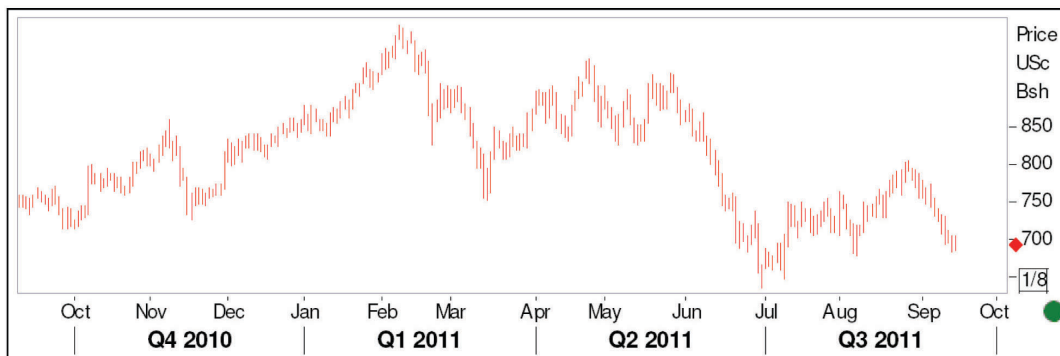
There was a period of strong new-crop sales before the marketing year began, but they have been dwindling. To illustrate, consider that since the beginning of the marketing year that began in June, weekly commitments have averaged 463,000 tonnes, compared with a weekly average of 809,000 tonnes during the same period in 2010.

This explains why news of the shrinking supply of milling quality wheat has failed to inspire any rallies in the wheat market. Prices are still sky high by historical standards, and with a reasonably well stocked pool of global inventories, demand for US wheat will remain weak. The excellent sales we saw in 2010 occurred when prices were closer to \$5 per bushel and have tailed off since.

In addition, Australia, a key exporter to Asia, is expected to have an excellent crop. A recent ABARE (the Australian equivalent of the USDA) estimate puts 2011-12 Australian exports 3 million tonnes above the USDA estimate of 17 million tonnes. And quality is expected to be much improved over last season. So even with the quality concerns in the Northern Hemisphere crops, there are compensatory factors elsewhere in the world.

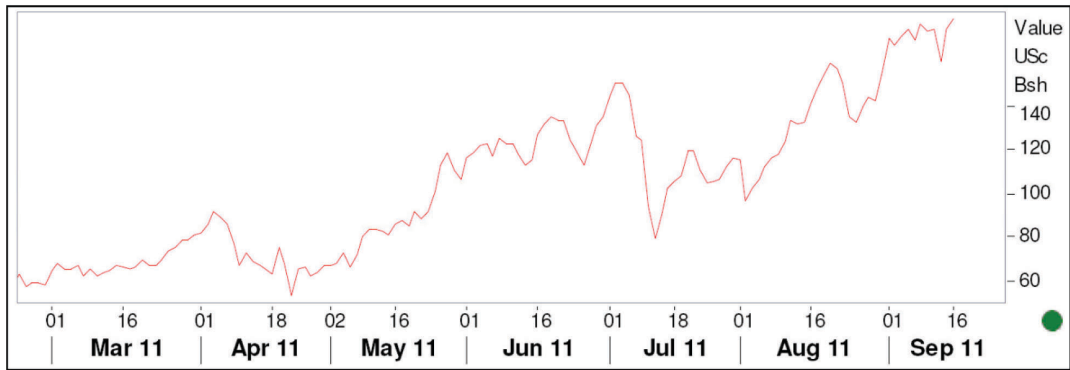
We recommend establishing short positions in December Chicago Board of Trade wheat, using initial sell stops of \$8.10 per bushel, close only. [September 16, 2011]

Chart 5 – Weekly nearest contract CBOT wheat



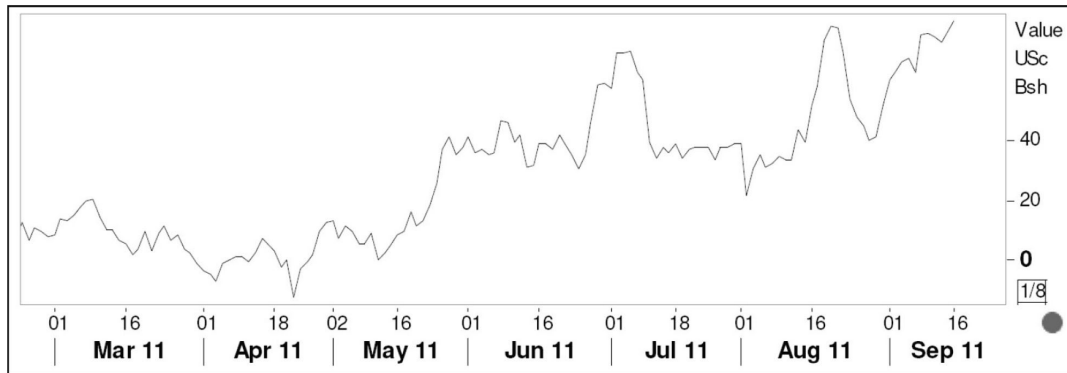
Courtesy Reuters

Chart 6 – Minneapolis/CBOT spread



Courtesy Reuters

Chart 7 – Minneapolis/KCBT spread



Courtesy Reuters

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