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Cocoa: still in transition

"Cocoa: in transition" was the title of a recent article we published on the cocoa market (*Focus on Futures*, July 2000). In it, we presented the case for what we believed to be the end of the bear market. Unfortunately, the market slid by an additional \$100 per tonne. Hardly a transition, it would seem. In the past few weeks prices have stabilized just above multi-decade lows. Is there any reason to assume that this little push off the bottom is anything but another lull in this severe bear market? We believe that this market, indeed, remains in a state of transition. Thus far, the market has ignored the early warning signs, which presents bullish traders an opportunity to get into this market while the bull is still in its infancy.

Burdensome carryover stocks have manifested themselves in the form of huge carrying charges in the futures markets. Consider Chart 1, nearest-contract cocoa, which illustrates that spot prices are higher now than they were back on March 1. During the same period, March cocoa dropped from \$906 to the current \$775 per tonne. While in itself this tells us only that the market is building a base, there is evidence that the current environment is different, because the spreads between March and May have actually begun to narrow both in New York (Chart 2) and in London (Chart 3). We've seen similar patterns develop before, but they would typically appear near contract expiry and disappear as soon as the expiry dealt with a lopsided open interest issue, etc. (Chart 4). With the nearest delivery month so far away, we believe that something of a more permanent nature may be afoot.

With carryover stocks reportedly still hovering near 40% of consumption, it would be difficult to proclaim a tight market. Still, two important issues whose developments we have monitored in many previous discussions of this market have turned to the bullish side.

First, Ivorian production. The Ivory Coast has been cranking out crops of over 1 million tonnes, or about one third of global production, since 1995. According to E.D. & F. Man's December 14 report, Ivorian production for the 2000-01 season will suffer a large setback, yielding a crop of only 1.21 million tonnes, 14% smaller than last year's crop. Although the headlines like to focus on civil unrest and the resulting labor shortages, Man makes it clear in its report that slower rate of arrivals *vis-à-vis* last year are a result of a lower pod load. Our past concerns about aging trees are being realized.

Output in the other main producing countries – Ghana, Indonesia, and Nigeria – will be roughly the same as the 1999-00 season, so they cannot be counted on to pick up any of the slack left by the Ivory Coast crop. Malaysia and Brazil are inching their way off the production map.

The second item we refer to also appeared in the Man report and seemed to pass without any fanfare. As we've noted in the past, the existing reporting system for grindings, focuses on US, UK, German, and Dutch grindings. Over the past few years, grinding activity in origin countries has increased significantly. We've maintained that it would take some time until all grinding data are properly incorporated into the system. Man confirmed this by raising its estimates of 1999-00 grindings to 7.9% from its November estimate of 6.7%, because of fresh export data of products that became available from Malaysia and Indonesia. Man interpreted the larger than expected exports to mean that grindings in these countries were higher than previously believed.

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

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In its November report, Man estimated that 2000-01 grindings would slip back to a growth rate of 2%. We believe this estimate is motivated by the buildup of stocks of products. Our first look at consumption data for the new season will be the quarterly grinding data from the the "big four" Western grinders due early in the new year. We reserve judgment until then.

With lower production for the new season and improved consumption in the season past, Man estimates a deficit of between 100,000 and 150,000 tonnes for the end of the 2000-01 season.

The open interest remains at historically high levels (Chart 5). When the market was attempting a breakout, we believed the shorts would be caught. When the market attempted a breakdown, it was only logical to assume that the longs would be the losers. Some believed that an option expiry would rid the market of the excess baggage. With a large chunk of the excessive open interest being tacked on during the last major downleg, this could be a bear trap, and the open interest "problem" once again looks like it will be resolved to the upside.

[December 27, 2000]

STRATEGY: Remain long March cocoa as per Flash Update of December 21. Raise stops to 728, close only.

Chart 1 – Nearest Contract Cocoa



Chart courtesy of Reuters

Chart 2 – New York March/May Cocoa Spread



Chart courtesy of Reuters

Chart 3 – London March/May Spread

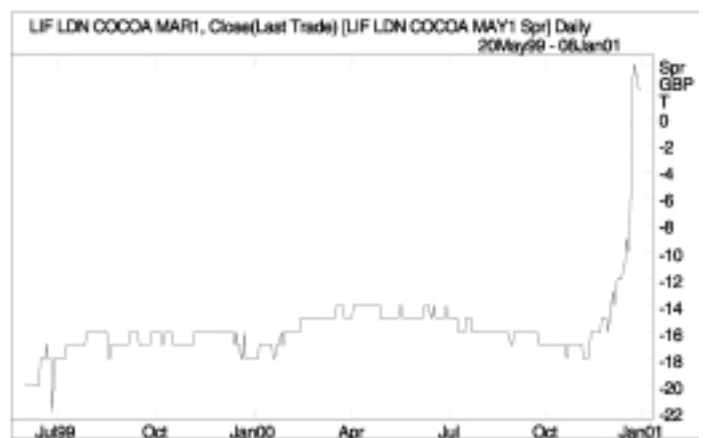


Chart courtesy of Reuters

Chart 4 – Nearest Contract/2nd Nearest Contract Spread

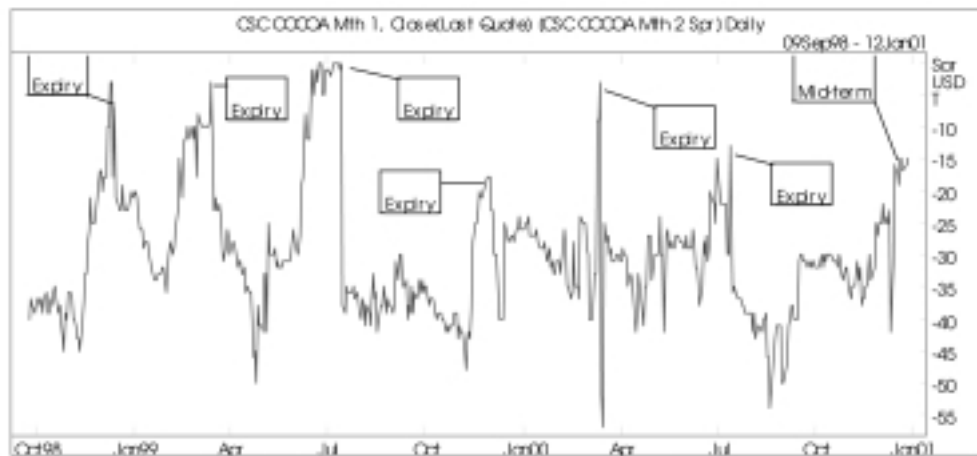


Chart courtesy of Reuters

Chart 5 – New York Open Interest

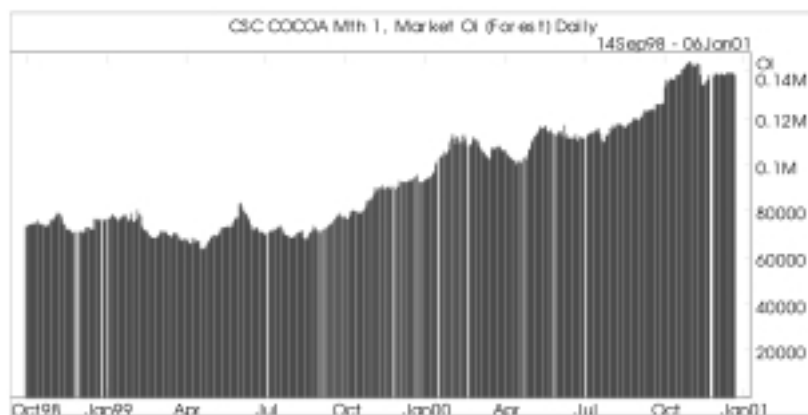


Chart courtesy of Reuters

COPPER

We're singing a different tune

Yes, that's right, we were long copper only a week ago, boldly proclaiming that the bull market is alive and well. And now we've gone short. What's changed?

Our bullish argument was centered mostly on the fact that despite a noticeable downtick in demand, the global deficit was persistent. The most recent statistics available indicate that this is still the case. In its December report, The International Copper Study Group (ICSG) estimates that the market still stood at a refined production/consumption deficit of 393,000 tonnes at the end of the third quarter.

While it is clear that at the very least, the US economy is no longer growing at the pace of recent years, we brushed off the immediate connection between copper prices and a slowing economy. Naturally, the consumption rate of industrial commodities should be expected to contract to some degree along with a slowing economy. In fact, copper traders have been using the stock market as a leading indicator of economic activity. The December rally in copper prices tracked stock prices rather closely, ending on the very day of the top of the rally in stocks (Chart 6) and proceeded to shed 6¢ per pound.

The connection between stocks and the prices of industrial commodities exists, but it is not tight. It is based on the belief that the extraordinary bull market in stocks created a wealth effect that allowed the economy to expand well beyond what textbook economics would have predicted. With the air rapidly seeping out of the Nasdaq balloon, the longest post WWII expansion would finally end. All the trappings of slower growth – including weaker commodity prices – would follow. Rather than draw conclusions from a turn in macro-economic fundamentals, we chose to focus on the apparent fundamentals of the copper market itself. And now, there is some evidence that the bullish fundamentals of copper are indeed being affected by a slower economy.

The changes are subtle, but they do indicate that both the supply and demand sides are turning. Table 1 shows that for the past three reporting periods, mine production inched upwards while usage inched the other way over the comparable period in 1999.

Table 1

PERIOD	GROWTH OF GLOBAL MINE PRODUCTION OVER 1999	GROWTH OF GLOBAL CONSUMPTION OVER 1999
JANUARY-JULY	1%	9.1%
JANUARY-AUGUST	1.3%	7.6%
JANUARY-SEPTEMBER	2.2%	7.3%

Chilean production figures released just the other day show output on its way back up again. Output for November rose by 8.2%, year-over-year. This compares with an increase in October of 7.7%, and *decreases* in September and August of 3.9% and 2.1%, respectively. Year-to-date Chilean production is growing at 5%.

Perhaps the most poignant development is the sudden turnaround in the direction of LME warehouse stocks (Chart 7). The bull run in copper prices was accompanied by a dramatic drawdown in warehouse stocks, which fell from close to 850,000 tonnes to 330,000 tonnes over the past 10 months. In the past week, we've seen the biggest, multi-day increase in warehouse stocks – 23,000 tonnes. Something of a confirmation of the global nature of the move comes from China, where stocks rose at the Shanghai Futures Exchange warehouses by close to 12,000 tonnes last week.

To be sure, the relationship between warehouse stocks and prices is not perfect, as far as timing is concerned. LME warehouse stocks did not peak until early March of this year. By the time the inventories began to reverse to the downside, copper prices had already rallied from 61¢ per pound to as

high as 87¢ per pound (Chart 8). When the stocks began to come down in earnest, the bull took a break, with the market falling about 10¢ per pound. Our bearishness may very well turn out to be premature.

Cash costs of much of the copper produced around the world remains under 50¢ per pound. The loss of production capacity seems to have been temporary as expensive mines in the West were closed and output was shifted to lower-cost mines in Third World countries. No doubt the bull market we've been experiencing was genuine in the sense that there is a new-supply/demand deficit that was complemented by economies growing around the world at a torrid pace. The transition to lower-cost mining, however, may be complete.

So with the downtrend in production probably over, a backdrop of a weakening economy, a *potential* buildup in warehouse stocks, and a widening contango in London, we believe that this market has, at least temporarily, seen its highs.
 [December 29, 2000]

STRATEGY: Remain short March copper as per Flash Update of December 26. Lower stops to 87.10, close only.

Chart 7 – LME Warehouse Stocks

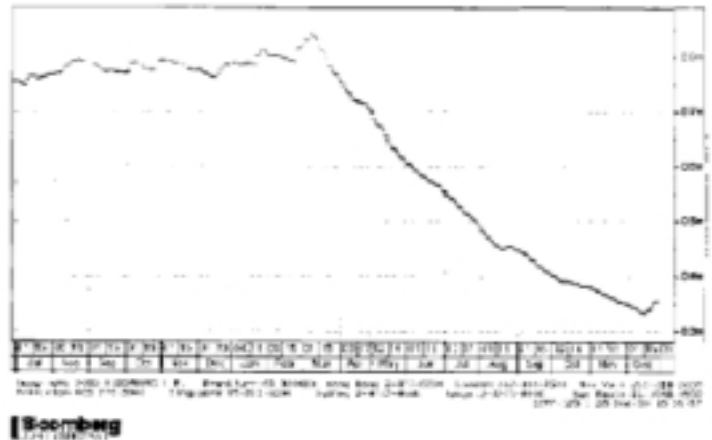


Chart 6 – March Copper, S&P 500



Chart courtesy of Reuters

Chart 8 – Spot New York Copper



Chart courtesy of Reuters

SOY COMPLEX**Ending stocks continue to shrink
as US exports come storming back**

Since the Mad Cow disease issue surfaced in mid-November, January soybean meal has been on a tear, rising \$25 per ton, or about 15%. During the same period, soybeans rose as much as 5%, and that is being quite generous by not including the recent 15¢ per bushel pullback. The divergence is depicted vividly by a ratio chart of the two instruments (see Chart 9).

European hog and poultry farmers are faced with the task of replacing three million tonnes of bone and meat meal over the six-month life of the EU ban. But is there really a shortage of beans? Or are we to assume that the Mad Cow disease outbreak alone was responsible for this rally and that once the market adjusts, prices will find their way back to the previous range? After all, the US harvest is now available, and by the time any further tightness has a chance to develop, the South American harvest will begin. The relative strength of meal prices makes the latter look like a plausible scenario as EU farmers scramble to replace their bone and meat meal supplies.

For this reason, we believe that the correct strategy at this time is specifically to be long nearest contract meal. Having said that, we also believe that the bean market itself had strong underpinnings to begin with, and Mad Cow disease has the potential to be the "accident" that pushes the whole market to serious tightness.

As expected, the December USDA supply/demand situation report made the necessary adjustments to account for the fresh demand. For the US, it raised its estimate for bean exports by 25 million bushels and crushings by 5 million bushels above the November estimate. This will draw ending stocks down to 320 million bushels, or 11.6% of consumption.

While the USDA kept its production figure at 2.777 billion bushels, unchanged from November, Sparks Commodities surprised the market yesterday by lowering its estimate for US production from its November estimate by 47 million bushels to 2.71 billion bushels from 2.757 billion bushels. Using the Sparks revision would drop ending stocks down to 273 million bushels, or a very exciting 9.9% of consumption. This compares with the November estimate of 12.8%, 10.6%, and 13.4% for 1999-00 and 1998-99, respectively.

To put a 273-million-bushel US carryover into perspective, let's remember that the USDA kicked off the 2000-01

season this past summer with an estimate for ending stocks of 600 million bushels. While traders have driven prices up by 50¢ per bushel from the summer lows, we believe that from a historical perspective, a price of \$5 per bushel for soybeans with a 273 million carryout reflects much complacency.

At the global level, despite an upward revision of 1 million tonnes in production, ending stocks will be drawn down by 1.35 million tonnes from the November estimate to 23.39 million tonnes because of an even larger upward revision to usage of 2.23 million tonnes. Global ending stocks will represent 13.9% of consumption compared with 14.7% at the end of 1999-00 and 16.3% at the end of 1998-00.

Recent US export activity has been very strong, supporting the USDA's upward revision to exports of both beans and meal. New sales of soybeans for the past 4 weeks averaged 989,000 tonnes compared with the average of the previous 4 weeks of 552,000 tonnes. At the end of November total commitments were running neck-and-neck with last year's pace. Now they are running 12.8% ahead of the same time last year.

Soybean meal activity almost doubled to an average of 197,000 tonnes these past 4 weeks from an average of 125,000 tonnes in the 4 weeks prior.

The meal is the red-hot market. Heavy speculative activity is evident from the huge increase in the open interest of both beans and meal. The inversion in meal, however, continues to grow (Chart 10). That represents bona fide tightness, which makes us feel comfortable that this market has not been overextended by over zealous speculators.

We're keeping a close eye on the beans. For now, we'll ride the stronger horse. *[December 29, 2000]*

STRATEGY: *Roll long January soybean positions to March. Adjust stops to 182.70, close only.*

Note: The December 1 issue of *Focus on Futures* titled "Mad Cow sparks the bull" began with the following sentence: "In our October 26 issue we attributed sagging soybean prices to a *weak* US dollar, but argued that importers had needs that would surface eventually." It obviously should have read "In our October 26 issue we attributed sagging soybean prices to a *strong* US dollar, but argued that importers had needs that would surface eventually." We apologize for the error and regret any confusion it might have caused. – S.S.

Chart 9 – Soymeal/Soybean Ratio



Chart courtesy of Reuters

Chart 10 – March/May Soymeal Spread



Chart courtesy of Reuters

GOLD

Can gold regain its reputation as a hard asset?

Gold prices face a strenuous test in the coming months. Many of the factors that have kept gold prices so weak for so long have been fading away.

In our last discussion of gold, we talked about our negative bias on the US dollar. The dollar has since fallen significantly. When measured by the Dollar Index, it has shed 7.5% of its value since it peaked in late October (Chart 11). Daily comments by the news media, who – as their mandate dictates – have to create daily comments whether there is anything of substance to report or not, make much of the relationship between gold prices and the movement of the dollar and often seem puzzled when gold doesn't do its thing with the dollar.

True, demand for gold, as well as all internationally traded commodities, should increase with a weaker dollar, and eventually drive prices higher. Nevertheless, despite the move in the dollar, neither gold nor any other commodity we know of has been so affected. But that's okay. We do not expect to see gold move in lock-step with the dollar. Gold bulls who fret every time the euro has a great day and gold does nothing are going to have a difficult time maintaining long positions in this market.

Gold prices did not fall *because* the dollar was strong, and they will not rise when it weakens. The important thing to understand is that if the dollar continues to weaken, a significant roadblock will have been removed. Over time, the purchasing power handed to Europeans and Asians with a weaker dollar will stimulate demand for gold, both as a commodity and as an investment vehicle.

Almost without fail, rallies in gold in the past few years have been associated with short-covering rallies by producers unwinding hedges. Some of the more notable instances involved troubled gold miner Ashanti back in the autumn of 1999. Another instance occurred when Barrick Resources announced plans to pare back its formidable hedging program earlier this year (Chart 12). Although much of the hedging activity happens out of the public eye in the over-the-counter market, open interest levels at Comex have generally mirrored this activity. As such, we cannot count on short covering for rallies, because open interest has been dropping dramatically for over a year. It has fallen from 225,000 contracts in September 1999 to its current level of 110,000 contracts (Chart 13). Open interest was last this low in 1993, just before an \$85-per-ounce rally. Traders are obviously not very

interested in this market. We will not be able to attribute a rise in price – or fall for that matter – to the long or short contingents, because neither group has much of a position in the market to speak of.

Some analysts see the absence of shorts as a bearish factor. Indeed recent history has shown that in the short run, it is. The flip side, however, is that if gold prices were to break out of their current monotony, the rally probably would be inspired by a wave of investment demand, and unlike the rallies we have become accustomed to, it may last.

Now that we know that rallies will be for real and the dollar won't stand in the way, why should we expect investors to flock to gold? Worrying about inflation has not been a popular pursuit among investors. They've been told it can't happen.

But what about the stock market? It may recover, or it may not. Doesn't really matter. Investors have been shaken and will be on a hunt for value. In an article that looks ahead to the prospects for the stock market in 2001, this week's *Barron's* summarizes what investors will be looking for:

“The pendulum is apt to swing back to sobriety...Expect to hear a lot more, as 2001 unfolds, about old-fashioned analytic tools, like price-to-earnings, price-to-cash flow, even price-to-book value – that is, if anyone remembers what hard assets are.” We feel confident that gold will be a beneficiary of the uneasiness amongst investors, caused by the implosion of so many worthless companies. A search for hard assets will become to the early 21st century what dot-coms were to the late 20th century.

Timing is of the essence, however, but we think we're not far off. We draw attention again to the open interest and the apathy that it symbolizes. A contrarian must be excited by a gold market whose participants have made it very clear that they have absolutely no interest. It brings to mind an old and tired cliché: Never sell a dull market short. *[December 31, 2000]*

CURRENT STRATEGY: *Our 270 sell stop, basis February, was triggered. Liquidate February gold as per Flash Update of January 2.*

Chart 11 – Dollar Index



Chart 12 – Spot Gold

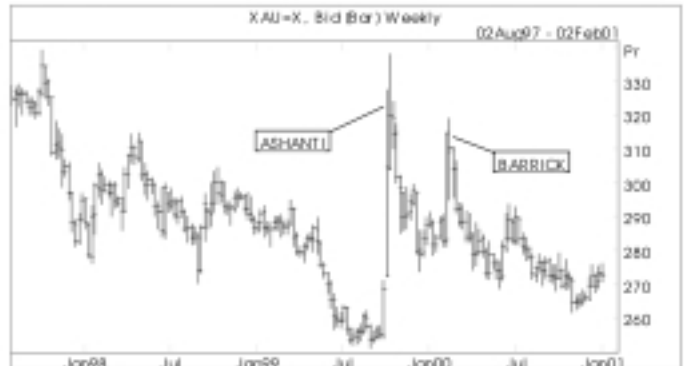
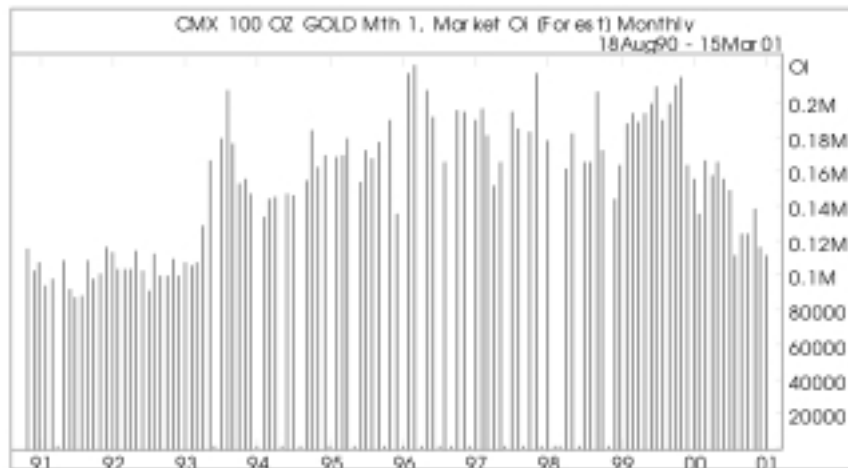


Chart 13 – Comex Gold Open Interest



Charts courtesy of Reuters

HOTLINE UPDATE

Flash Update – Monday, November 27, 2000:

Good morning for Monday, November 27, 10:45 am. This is a Flash Update. We have purchased March sugar at 10.14, placing our initial stop at 9.25, close only.

Flash Update – Friday, December 1, 2000:

Good afternoon for Friday, December 1, 12:00 pm. This is a Flash Update. We have liquidated our long March sugar position at 9.65.

Friday, December 1, 2000:

Good afternoon for Friday, December 1, 4:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March copper, with our stop revised to 82.90, and long February gold, with our stop revised to 266. All stops are close only.

Flash Update – Tuesday, December 5, 2000:

Good morning for Tuesday, December 5, 9:45 am. This is a Flash Update. We have purchased March wheat at 279¹/₂, placing our initial stop at 273¹/₂, close only.

Flash Update – Thursday, December 7, 2000:

Good morning for Thursday, December 7, 9:10 am. This is a Flash Update. We have purchased January soymeal at 187.20, placing our initial stop at 177.20, close only.

Flash Update – Thursday, December 7, 2000:

Good afternoon for Thursday, December 7, 12:05 pm. This is a Flash Update. We have one new recommendation. We have liquidated our long March wheat position at 274. We repeat our Flash Update from earlier today where we purchased January soymeal at 187.20, placing our initial stop at 177.20, close only.

Friday, December 8, 2000:

Good afternoon for Friday, December 8, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March copper, with our stop revised to 83.50; long February gold, with our stop revised to 270; and long January soymeal, with our initial stop at 177.20. All stops are close only.

Flash Update – Wednesday, December 13, 2000:

Good morning for Wednesday, December 13, 9:05 am. This is a Flash Update. We purchased March crude oil at 28.51, placing our initial stop at 27.00, close only.

Flash Update – Thursday, December 14, 2000:

Good morning for Thursday, December 14, 11:20 am. This is a Flash Update. We have liquidated our long March crude oil position at 26.90.

Friday, December 15, 2000:

Good afternoon for Friday, December 15, 4:35 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March copper, with our stop at 83.50; long February gold, with our stop at 270; and long January soy meal, with our stop revised to 182.50. All stops are close only.

Flash Update – Thursday, December 21, 2000:

Good morning for Thursday, December 21, 9:20 am. This is a Flash Update. We have liquidated our long March copper position at 84.95, and we have purchased March cocoa at 770, placing our initial stop at 715, close only.

Friday, December 22, 2000:

Good afternoon for Friday, December 22, 4:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long February gold, with our stop at 270; long January soymeal with our stop revised to 187; and long March cocoa, with our stop revised to 728. All stops are close only.

Flash Update – Tuesday, December 26, 2000:

Good morning for Tuesday, December 26, 9:20 am. This is a Flash Update. We have sold short March copper at 85.65, placing our initial stop at 88.50, close only.

Flash Update – Thursday, December 28, 2000:

Good afternoon for Thursday, December 28, 12:05 pm. This is a Flash Update. We have rolled over our long January soymeal positions into March, placing our new stop at 182.70, close only.

Friday, December 29, 2000:

Good afternoon for Friday, December 29, 4:50 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long February gold, with our stop at 270; long March cocoa, with our stop at 728; short March copper, with our stop revised to 87.10; and long March soymeal with our initial stop at 182.70. All stops are close only.

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