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Can foreign production put a lid on soybean prices?

Soybean prices are once again pushing up towards their 2002 highs (Chart 1). Are we just wandering aimlessly in a $5.50- to $5.80-per-bushel range, or are there reasonable prospects that the market will move through the previous highs?

Supply

The US – the world's largest producer and exporter – grew a 2002-03 crop that was 7% smaller than the previous year's, leaving the smallest carryout since the bull market of the mid-1990s. Still, if there is a bearish case, it is on the supply side, because of foreign production, primarily from South American output.

In the November supply/demand situation report, the USDA was very generous with upwards revisions to output for all major producers -- the US, Brazil, Argentina, and China. In total, the revisions amounted to an additional 4.3 million tonnes, a rather hefty 16% increase in production above estimates found in the October report. All these forecasts were maintained in its December report. Aside from the US crop, which has been harvested, the USDA's optimism could be a bit premature.

It was a surprise that the USDA kept both Brazilian and Argentinean production at 49 and 32.5 million tonnes respectively. While acreage has increased enough to vault the combined output of the two countries ahead of US production, farmers in both Brazil and Argentina experienced difficult planting conditions in October and November.

The USDA is apparently using nothing more than the change in acreage from last year to calculate the final crop estimate. For example, Argentinean soy acreage is expected to grow to 12.6 million hectares, up 8.6% from 2001- 02. The 32.5-million-tonne crop projected by the USDA, an 8.3% increase over 2002-02, is roughly equivalent to the percentage increase in planted area.

This was acceptable for the November and December reports, because most of the data used would have been collected before there was any significant progress in the planting season. By now, however, we know that weather problems delayed some planting activity past the optimum seeding periods, which could result in some yield loss. Traders were almost certain that there would be some reduction in the South American estimates. In fact, on the day of the release of the December USDA report, the Brazilian Agriculture Ministry released its estimate for a crop of only 47.6 million tonnes, 1.4 million tonnes below the USDA estimate. To achieve the USDA estimates, we will need ideal climatic conditions from here on in. The pod-setting period begins in January and will require ample precipitation, so at the very least we are likely to maintain a weather premium in the near term.

The USDA pegged the Chinese crop at 16.4 million tonnes, up 1 million tonnes from the 2001-02 season. There is much less information available about the Chinese situation, but press reports have quoted trade sources that indicate that the crop is actually closer to 15 million tonnes. This is particularly significant because, aside from the EU as a whole, China is the world's largest importer of soybeans.

Demand

Even after accounting for the USDA's increased output estimates in its December report, growth in global demand will outstrip production. Production will rise by 4.5 million

Inside

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

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tonnes, or 2.4%, over 2001-02, to 188.8 million tonnes. Consumption will jump by 7.2 million tonnes, or 3.9%, to 191.19 million tonnes.

The key item to monitor is US exports. The USDA estimates that US soybean exports will reach only 24.49 million tonnes this season, 4.43 million tonnes, or 15%, below last year's exports. While the pace of export commitments earlier in the season supported this view, recent sales have been very strong. To illustrate, about 1 month ago, export commitments were running 9.6% behind the same time last year. Since then, commitments have averaged just over one million tonnes per week, considerably higher than typical weekly tally for soybeans. While this pace is probably not sustainable for very long, it has brought total commitments for the year within only 5.7% of last year's pace. Now, even a modest weekly flow of exports for the balance of the season would be sufficient to push US exports to meet last season's level.

In conclusion, if the USDA's rosy outlook for foreign production increases comes to fruition, then, indeed, the market becomes a bit rich at $6 per bushel. With strong demand, however, the $6 level would be less of a challenge to overcome. If the USDA production data are behind recent developments and demand remains firm, we should bolt right through the overhead resistance and head for prices last seen in the mid-1990s. *[December 27, 2002]*

STRATEGY: *Remain long March soybeans as per Flash Update of October 18. Raise stops to 540, close only.*

Chart 1 – March soybeans

Courtesy Reuters

COCOA

Can the cocoa crop find its way to the ports while unrest persists in the Ivory Coast?

Cocoa prices have advanced about $400 per tonne since tensions in the Ivory Coast were rekindled earlier this month. Bears, however, could find grounds to dismiss the significance of the rally.

Despite all the press reports suggesting that production, processing, and transportation of beans has been hampered, the release of the December E.D.&F. Man report seemed to provide a sobering look at the market.

Man has maintained its September estimate of the 2002-03 Ivorian crop at 1.175 million tonnes, chopping only 65,000 tonnes off the 2001-02 crop to account for all the mayhem. In fact, we've been told that Man delayed the release of the December report, owing to some restrictions on collecting data because of the fighting. Man did not want to publish anything until it had a chance to present a clear picture. A testament to Man's credibility in this market: Since its report was released on December 11, prices have made little progress.

Recent developments, though, make it difficult to believe that the fighting has not reduced available supplies and hurt quality to a greater extent than being estimated by Man.

Arrivals at Ivorian ports had reached 550,000 tonnes by December 20. Typically, about half of the total crop arrives by the end of December. By this count, we are about 75,000 tonnes shy of Man's 1.175-million-tonne estimate. Exporters say that daily arrivals have slowed down to about half the usual pace, leading them to believe that there are not many more beans left to be seen from the main crop. Last year, by January 7, arrivals had reached 720,000 tonnes. Given the current pace, this milestone would be almost impossible to achieve.

Furthermore, aside from the quantity issue, officials at the Cocoa and Coffee Bourse in the Ivory Coast have indicated that at least some of the beans that have arrived at port have not been dried properly and are moldy. Apparently, farmers are hurrying the drying process because of fears that they will not be able to market their beans at all if the conflict were to reach their doorstep.

Of course, it is a stretch to believe everything you hear from a war-torn country, but there is no question in our minds that the situation remains volatile and leaves the avaiablity of supplies very vulnerable.

On the demand side, Man confirmed a point that we have made several times in these pages. While demand – as measured by grindings – had a dismal season in 2001-02, falling 7.6%, the weakness cannot possibly persist indefinitely. The slow pace of grindings has caused a shortfall in the inventories of the products that are used in the manufacture of chocolate. This has increased the prices of the products, which is making it profitable to grind once again. Man expects only a modest 3.6% recovery in grindings.

Man expressed concern about the effect of higher prices on chocolate consumption, but recently released data show that confectionary sales in both the US and Europe have gained ground over the past year, despite higher prices. These statistics have led some analysts to be far more optimistic about the recovery in grinding activity, with estimates for an increase of as much as 8%.

Whether one feels completely comfortable with the rather sketchy bullish fundamentals or not, the "long community" is not the one feeling the heat. The most recent Commitment of Traders data show that despite covering about 2,000 contracts of their net-short positions, commodity funds still remain short 13,533 contracts. The small spec group carries a modest net-long position, and actually liquidated part of that position on the recent rally, leaving it net-long 2,000 contracts.

We have no intention of sinking with the ship and have therefore tightened our stop up to just below the low of the recent consolidation. The coming weeks are crucial – as illustrated above – as we watch to see if the trickle of beans currently arriving at the ports returns to a proper flow. If it does not, we expect the October highs to be quickly eradicated.

[December 27, 2002]

STRATEGY: *Remain long March cocoa as per Flash Update of November 19. Raise stops to 1975, close only.*

SILVER

How about silver?

Gold has left silver in the dust. Gold prices closed out 2002 at $93 per ounce, or 37%, above the $253-per-ounce low recorded in August 1999 (Chart 2). While gold is trading at 6-year highs, silver, even after a strong finish in 2002, is 6% below the high it set this past summer (Chart 3). The gold/silver ratio has moved up to 74-to-1, its highest level since early 1997 (Chart 4). Silver had its moments vis-à-vis gold during this period, but overall it has underperformed gold in modern history. Has the traditional relationship between the two metals become a relic?

As a general industrial metal (excluding photography use), silver has been suffering because of weak economic conditions. In 2001 global industrial consumption dropped by 39 million ounces, or more than 10%, from the previous year. While this area of demand will fluctuate with economic activity, demand from photography use is probably in permanent decline as the digital camera rapidly becomes a household item.

No silver is used in either the camera or film development process of digital technology. Until recently, photography use represented about 25% of total silver consumption. As digital technology becomes increasingly commercially viable, silver's use in the photography industry should begin to decline significantly. In 2000, usage fell 6 million ounces, or 2.5%, to 220 million ounces. In 2001 consumption dropped 10 million ounces, or 4.5%, to 210 million ounces. We don't know of any reason this trend should not continue.

Some argue that the decline in silver use in photography was in line with lower general demand tied to weak economies and a decline in tourism in the post-9/11 world. Statistics show clearly, though, that sales of digital equipment, particularly in the US, have been growing at a torrid pace.

Between the photography issue and silver's dependence on economic recovery – which at this point is rather murky – there is little in the way of positive "commodity" fundamentals to inspire bulls.

The question is, though, can any of the factors that are driving gold prices higher benefit the silver market? Well, some will and others will not.

Primarily, there is one big negative in this comparison study. One of the bullish dynamics for gold prices is the transition in the hedging sector, and this is completely absent from the silver market. Many large mining companies have dropped their hedge programs, choosing not to sell their production forward so they can reap the rewards of rising prices. Even more significant in the shorter term is the existence of a large hedge book, which will ultimately have to be covered as the new, hedge-free mandates among mining companies are put into place.

Otherwise, silver should be able to tag along. The US dollar has fallen 15% (Chart 5) since it began to decline in early 2002. All internationally traded, dollar-denominated assets stand to gain from a cheaper dollar; silver is no different.

Silver may not share gold's glitz, but it does possess the basic attributes of a hard asset and a store of value that can protect against the uncertainties of an increasingly volatile geopolitical climate. Whether the protection is real or psychological doesn't really matter. If it is effective in underpinning a bull market in gold, it will ultimately have a similar, albeit lesser, effect on silver prices.

The bear market in equities has created a monumental shift in investors' attitudes towards the stock market. Investment dollars will be on the hunt for alternative strategies and long-forgotten investment vehicles, such as precious metals, are obviously among the candidates. Again, silver will not be excluded from this category.

Open interest in gold has rocketed to 205,000 contracts, more than double the lows set in August 1999, indicating that the speculative community has taken notice of the breakout. This is one small area where silver – for the moment – may have an advantage, assuming of course one buys the bullishconnection-with-gold argument. Silver open interest stands at 80,000 contracts, still a fair distance from the 2002 highs of 103,000 contracts and rather average from a historical perspective.

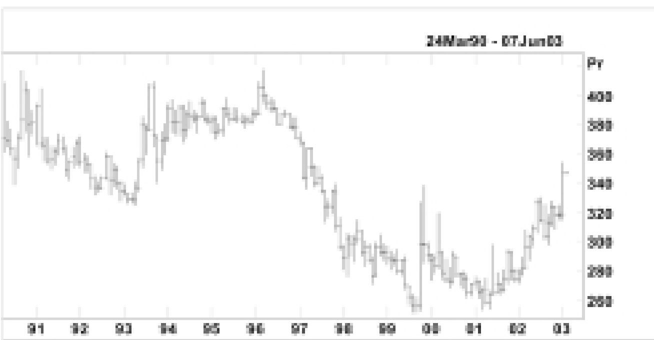
The Commitment of Traders data show that commodity funds are net-long 28,932 contracts, but still sharply below the 50,000 contract net-long position they held this past June. Gold, on the other hand shows a fund net-long position of 57,105 contracts, which is the largest long fund position since 1996.

When analyzing the open interest of gold, we should keep in mind that it is unique among commodities. We expect prices to thrive precisely because of the investment element, which means that growing open interest is not always an indicator of overbought conditions, provided it meets our stringent (proprietary) guidelines. Still, the moderate open interest levels in silver could very well mean that there is a good chunk of potential buying power on the sidelines.

Silver will probably ride gold's coattails. It is extremely cheap vis-à-vis gold, and as such, a value player might consider buying silver, but would look to switch back into gold once the gold/silver ratio moves back into the range it has established over the past five years. At present, however, gold is in gear, and momentum players would be well advised to bet the strongest horse. *[January 2, 2003]*

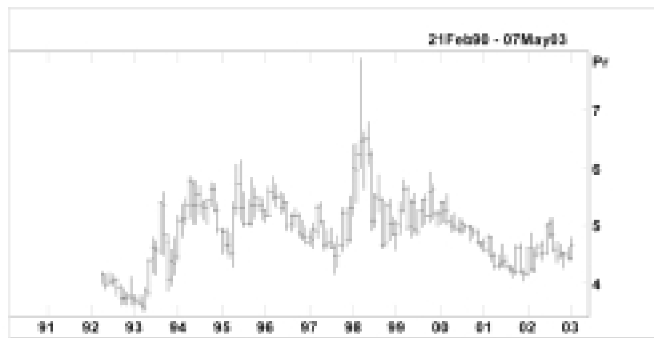
STRATEGY: *Stay tuned.*

Chart 2 – Spot gold



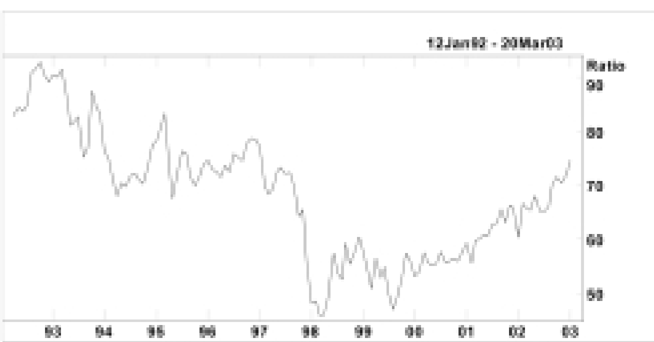
Courtesy Bloomberg

Chart 3 – Spot silver



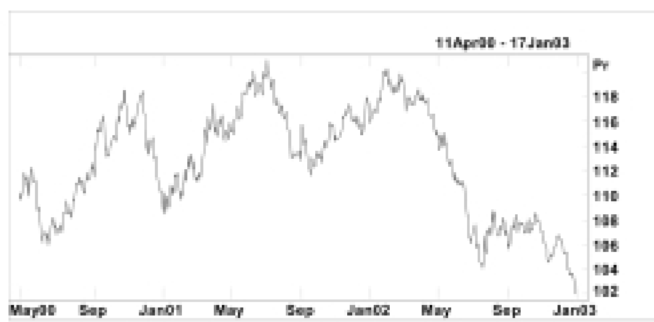
Courtesy Bloomberg

Chart 4 – Gold/silver ratio



Courtesy Reuters

Chart 5 – Dollar index



Courtesy Reuters

WHEAT

What a disappointment!

With a whole stable full of bullish fundamentals, it seemed that we were in for a sustained bull market in wheat. Not so simple, it turns out. Wheat bulls apparently were forced to absorb a lesson in a basic principle of commodity economics. You can get a bull run with supply problems, but the "sustained" part cannot happen if the demand side does not cooperate.

On the surface, the bullish argument remains compelling. In its December supply/demand situation report the USDA revised global ending stocks down from its November report by 3 million tonnes, to 169.49 million tonnes. As a percentage of consumption, stocks will drop slightly, to 28.3% from 29% in November, and will remain significantly below 2001-02 stock levels of 34% of consumption and 35% at the end of 2000-01.

Export estimates for the world's second, third, and fourth-place exporters, Australia, Canada, and Argentina – again, on the surface – indicate that there should be a shortage of exportable, food-grade wheat. In 2001-02 the three countries collectively exported 43.48 million tonnes of wheat. The USDA estimates that they will export only 22.8 million tonnes in 2002-03!

Nevertheless, the USDA estimates that global trade will fall only 6 million tonnes from 2001-02, to 102.6 million tonnes. So the shortfall created by the miserable crops of the traditional suppliers is obviously being made up by other countries. On December 27, the USDA attaché in Russia raised the USDA's December estimate for 2002 Russian exports to 8 million tonnes, from the 7.5-million-tonne estimate found in the monthly report. Last year Russia exported only 4.4 million tonnes. The Ukraine is expected to export 9 million tonnes, compared with last year's 5.5 million tonnes. India will sell an additional 3 million tonnes to foreigners, and the EU will tack on an additional 4 million tonnes to last year's sales.

US exports, on the other hand, are estimated to fall 3 million tonnes, to 25.86 million tonnes. Although the US had a dismal 2002-03 crop of 44 million tonnes, down 10 million tonnes from 2001-02, and stocks have been run down to the lowest level in history, there is wheat available for sale. Yet foreign buyers are turning away from US wheat. Average export commitments over the past 4 weeks were 239,000 tonnes, compared with 389,000 tonnes the previous 4 weeks. To reach the USDA's target of 25.86 million tonnes for 2002-03, exporters will have to sell an average of 420,000 tonnes per week.

Price is probably the primary issue. French and Russian milling-quality wheat, for example, sells for about $110 and $80 per tonne, respectively. Even after the dramatic drop in prices, US wheat now runs, depending on grade, between $120 and $130 per tonne. For most of the past 3 months, US wheat would have cost between $140 and $150 per tonne. It is not difficult to understand, then, the sudden disinterest in US wheat by foreigners. Naturally, there are disparities between the quality of US wheat and that of other countries, particularly Russian and Eastern European varieties. Still, price seems to be king.

Aside from sluggish exports, traders are assuming that we couldn't possibly have another disastrous growing season for winter crops currently in the ground to be harvested in the spring. In addition, the rich prices we saw earlier in the season reportedly inspired farmers to plant more acres than they have in recent years. If in fact US, Canadian, and Australian farmers do harvest more normal-sized crops, falling prices were indeed warranted.

That's the bad news. There is, however, an encouraging side for bulls. First, although we've had very sluggish export sales in the US, we're not running that far behind last year's pace, despite the recent nosedive in sales. As of the most recent reporting period, exporters sold 95% of what they sold last year at this time. March wheat has fallen more than $1 per bushel from its highs, and US exporters may very well be priced back into the market. French wheat prices, for example, have barely fallen from their October/November highs.

The weekly sales required to meet annual export estimates seem overwhelming only because of the poor sales we've become accustomed to over the past two months. But if the price is right, 420,000 tonnes per week is a fairly average number if we look back to past seasons and, indeed, not overwhelming at all when compared with some of the 600,000-tonne-plus weeks recorded earlier this season.

As far as the coming crops are concerned, it is early, and as we have pointed out in previous discussions on the grain markets, it could take more than one season to replenish subsoil moisture back to normal levels. The first signs of trouble have already appeared. The Kansas Agricultural Statistics Service reported on December 30 that December was drier than a typical December, and subsoil moisture levels were of concern in many regions. The good-to-excellent portion of the crop in Kansas, a key winter wheat state, has fallen to 50% from 62% at the end of November.

In conclusion, the wheat market has been walking a tightrope for several years now, because global consumption continues to outstrip production. Unfortunately for bulls, we keep finding replacement sources. We do feel, however, that complacency has worked its way into the trading pits because of the US export "drought" and hope for better crops. As illustrated, both of these situations can turn on a dime.

We're stopped onto the sideline, but we remain keen (and bullish) observers and prepared to jump back in if exports pick up. *[January 3, 2003]*

STRATEGY: *Stay closely tuned.*

HOTLINE UPDATE

***Flash Update* – Monday, December 16, 2002:**
Good morning for Monday, December 16, 9:10 am. This is a Flash Update. We have purchased March cocoa at 2045, placing our initial stop at 1750, close only.

***Flash Update* – Tuesday, December 17, 2002:**
Good morning for Tuesday, December 17, 9:15 am. This is a Flash Update. We have purchased March copper at 73.65, placing our initial stop at 72.50, close only.

***Flash Update* – Wednesday, December 18, 2002:**
Good morning for Wednesday, December 18, 10:30 am. This is a Flash Update. We have purchased March wheat at 361.5, placing our initial stop at 345, close only.

***Flash Update* – Friday, December 20, 2002:**
Good afternoon for Friday, December 20, 1:05 pm. This is a Flash Update. We have liquidated our long March copper position at 71.80

***Flash Update* – Friday, December 20, 2002:**
Good afternoon for Friday, December 20, 2:15 pm. This is a Flash Update. We have liquidated our long March wheat position at 341.75. We repeat our Flash Update of earlier today where we liquidated our long March copper position at 71.80

Friday, December 20, 2002
Good afternoon for Friday, December 20, 4:10 pm. The following is a recap of our current open position recommendations and our latest stop levels: We are long March soybeans, with our stop at 540; long February gold, with our stop revised to 315; and long March cocoa, with our stop revised to 1975. All stops are close only.

Friday, December 27, 2002:
Good afternoon for Friday, December 27, 4:20 pm. The following is a recap of our current open position recommendations and our latest stop levels: We are long March soybeans, with our stop at 540; long February gold, with our stop at 315; and long March cocoa, with our stop at 1975. All stops are close only.

Friday, January 3, 2003:
Good afternoon for Friday, January 3, 3:40 pm. The following is a recap of our current open position recommendations and our latest stop levels: We are long March soybeans, with our stop at 540; long February gold, with our stop at 315; and long March cocoa, with our stop at 1975. All stops are close only.

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