FRIEDBERG'S

FOCUS ON FUTURES

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Can the Ivorian cocoa crop survive another year of civil war?

Civil strife in the Ivory Coast flared up again in November, grabbing headlines and underpinning the recent rally. Prices have backed off considerably from last week's high of just under $1,800 per tonne in the wake of a developing truce between the parties of the conflict, the government and the rebels, but are still more than $200 per tonne above the mid-October low of $1,350 per tonne (Chart 1).

It is easy to get swept up by the hype surrounding the ongoing struggle. The implication conveyed by media reports is that fighting between the warring factions could lower cocoa output. That is certainly the impression we get from speaking to people in the industry.

One need only look at last season's crop results, however, for evidence that output should not be affected. At this point of the 2002-03 season, we were hearing forecasts for dramatically smaller output, but we ended up with a near-record crop. More realistically, the tension could manifest itself in supply interruptions from a slowdown in transportation of beans from plantations to ports. This, of course, means that the beans exist, but their appearance in statistics will be delayed.

A more serious and permanent fallout would come in the form of workers abandoning their jobs for fear of their lives, which would leave part of the crop unharvested.

With arrivals running even lower than last year's pace – a bullish case develops not only with anecdotal evidence, but with available statistics. At last count, only 350,000 tonnes of cocoa beans have made their way to the two principal Ivorian ports this season, 22% below last year at this time. At the recent pace of weekly arrivals, it is estimated that only 675,000 tonnes will arrive at port by the end of December, about 30% below last year's level.

One possible explanation for weak arrivals is the smuggling trade with neighboring Ghana, where farmers are receiving higher prices for their beans. There is no way of knowing how much cocoa is involved, but 100,000 tonnes is the figure cited in press reports. This supply issue is temporary, because while smuggling may shrink the final Ivorian tally, the beans will eventually show up in Ghanaian arrivals.

On the demand side, grind figures have been largely disappointing over the past few quarters. The US and European grinds gained less than 2% for the third quarter – a disappointment for bulls who believed that we'd be growing at better than 3% this year.

There is another demand indicator, however, which is showing signs of life and which should ultimately push grind results higher. End-product stocks, such as butter and powder, have been run down. As a result, butter prices have risen relative to bean prices, with the ratio now trading steadily above two times London futures in both Asia and Europe.

A rising ratio means it is becoming increasingly profitable to grind beans into products, which is likely to result in grinders ramping up bean purchases, which in turn could eventually tighten up the market. We haven't seen this figure consistently over 2 in some time. For most of this year, the ratio hovered between 1.5 and 1.75. It could be a seasonal factor, but not necessarily. Last year, in the period leading up to the holidays, this ratio was about 1.75.

So while the daily headlines focus on events that at best will have some short-lived effect on supply, they've ignored the demand side of the balance sheet, a component that could be far more bullish if it is indeed an indication that consump-

Inside

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

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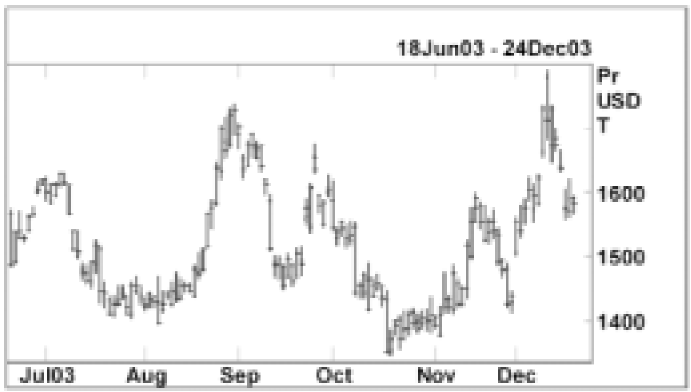
tion has grown beyond the market's expectations.

Back to the supply side, both E.D.&F. Man and Credit Lyonnais Rouse have pegged the 2003-04 Ivorian crop at levels that don't reflect huge crop losses. In its October report, Man estimated 2003-04 output at 1.3 million tonnes, just slightly less than last year, while Credit Lyonnais's more recent forecast put the main crop at 1.03 million tonnes. With a trendline mid-crop of 250,000 tonnes, the total crop would be just under 1.3 million tonnes. Both of these estimates were published before the current round of hostilities began, so it's difficult to say whether these analysts would maintain their forecasts in light of the recent developments.

We are looking at the long side. This is a very volatile market at the best of times. The on-again off-again civil war has caused the swings to be particularly violent. We've presented a mostly bullish case, but we maintain some skepticism because we are not convinced that the Ivorian crop will be affected. If there is a problem with the Ivorian crop and demand has really picked up, this market should be headed substantially higher. *[December 19, 2003]*

STRATEGY: *Remain sidelined, but stay tuned.*

Chart 1 – March cocoa



Courtesy Reuters

WHEAT

Global stocks continue to decline

Global wheat production continues to shrink. The 2003-04 marketing year marks the sixth consecutive season of declining output. Demand has remained fairly steady, which is probably the reason prices are not much higher, but smaller crops have drawn ending stocks down to their lowest level since the 1972-73 season.

For the most part, prices have been contained in a $2.50 to $4-per-bushel range. The wheat market has avoided any major trauma despite the fact that there have been crop failures in major producing/exporting countries in each of the last several years. This year, US, Canadian, and Australian crops are expected to return to normal size, but China is expected to have a smaller crop. Prices are currently hovering at the upper end of the band. Will the bull run fail as it did in September 2002 (Chart 2), or are we in the midst of a powerful bull market that will take us to much higher price levels?

In its December supply/demand situation report, the USDA revised its estimate for 2003-04 global ending stocks upwards by 1.6 million tonnes from its November estimate, to 127.93 million tonnes, or 21.8% of consumption. As a percentage of consumption, however, the carryover rose by only a whisker, from 21.6% of consumption, because the estimate for consumption rose as well.

Over the past several years, a popular notion that seems to surface in any discussion of commodities is that the standard for carryover stocks has undergone dramatic changes over the past decade. What was considered a low inventory level in the bull markets of the 1970s and 1980s may now be an amply supplied market.

Free trade pacts and improved technology have allowed users of commodities to maintain smaller inventories. This is a completely valid argument. If in fact such complacency does exist, central planners responsible for making purchasing decisions will tend not to "stock up" on commodities. Only unexpected and extraordinary events like crop failures could create sustainable bull markets.

Recent events, however, cast some doubt on whether the complacency theory is accurate. Witness recent Chinese buying of soybeans and cotton that drove prices up to multi-year highs. In the case of soybeans, the buying frenzy was driven by unexpected feed demand, while weather problems trimmed 20% off early season forecasts for the Chinese cotton crop. Can the Chinese buying binge spill over to the wheat market?

China has not imported much wheat in recent years. In the 1994-95 and the 1995-96 seasons, the Chinese bought 10 and 12 million tonnes abroad respectively. Since then, however, imports averaged less than 1.5 million tonnes. China can be considered self sufficient in wheat. But for how long?

The Chinese continue to draw down their inventories. The production/consumption deficit will be 17.5 million tonnes this season, after shortfalls of 15 million tonnes in both 2002-03 and 2001-02. On the surface, ending stocks of 43 million tonnes, or 41% of consumption, don't seem that low. They have been in a steep decline, however, falling from 57% of consumption 2002-03 and 70% in 2001-02. Unless we expect the Chinese crop to bounce back in the 2004-05 season, inventories will continue to fall, leading us to believe that it is only a matter of time before China will need to import wheat.

So far this marketing year, China has contracted to buy 400,000 tonnes of wheat from the US, a relatively small amount. But it is almost as much as the 430,000 tonnes China imported from all countries all of last year. Last week, China announced a purchase of 500,000 tonnes of Canadian wheat for 2004 delivery. Just this morning, the Chinese signed a deal with Australia to buy 1 million tonnes of wheat in 2004. Although in the short term this news is negative for US prices, it is obvious that China's needs are growing.

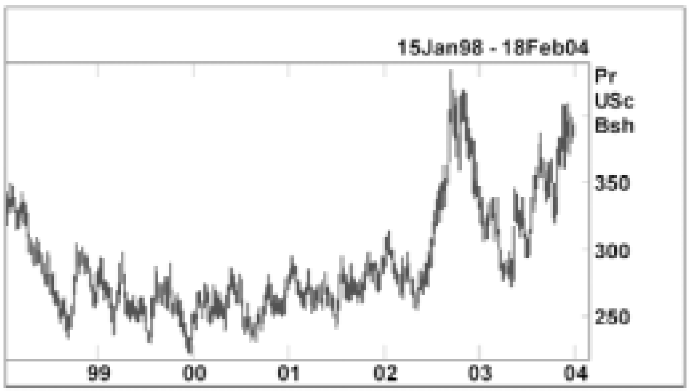
Aside from China, business has been brisk for US exporters. Commitments stand at 21.8 million tonnes, compared with only 16.3 million tonnes at this point last season. The USDA forecasts that total sales for 2003-04 will jump to 30 million tonnes, up sharply from last year's dismal 23.25 million tonnes.

In conclusion, this market is completely vulnerable to any supply- or demand-side accident. We probed the long side with a stop below the recent consolidation, and we were promptly stopped out. We still like the long-term prospects of this market, and we will be watching carefully.

[December 24, 2003]

STRATEGY: *Liquidated long March wheat as per Flash Update of December 23.*

Chart 2 – Weekly wheat



Courtesy Reuters

CORN

Mad *corn* disease?

On December 23, a single case of Mad Cow disease was found in a cow in Washington state. The infected cow has wreaked havoc with agricultural markets.

The largest and most direct effect – naturally – was seen in the price of cattle. February cattle prices have now fallen by 20¢, or more than 20%, since the news broke. Demand for beef is expected to fall in the United States. The public is assessing the potential risk of the dreaded disease spreading into the human food chain.

A more immediate and perhaps more significant issue is a multi-country ban on US exports. Countries such as Japan, Mexico, South Korea, and others import 2.584 billion pounds of beef from the US annually, about 10% of total US production. Shortly after the contaminated cow was identified, these importers responded to the news with announcements that they would be banning all US imports of beef.

Cows eat a lot of corn, and the grain market's initial reaction was a sharp selloff in corn prices. Fears that a potential, large-scale liquidation of cattle herds would reduce demand for carbohydrate feeds caused prices to tumble.

On December 24, the first session during which the market had a chance to digest the implications of the developing story, March corn fell by as much as 15¢ per bushel, about 6%, but finished the day down only 8¢ per bushel. By the time the market broke for the New Year's holiday, prices had recovered the entire "Mad Cow" loss and then some. The volatility was enough to shake out weak longs – including yours truly – at or near the low of the move.

The market action seems to indicate that the whole affair was a knee-jerk reaction. Commodity funds had begun to liquidate their massive long position before December 24. Quite possibly the news was hitting an already-weak market, which served only to exaggerate an in-progress, due-course correction by taking out key support levels and triggering stop loss orders. That's one theory that would explain the lack of follow-through to the downside and the handsome recovery.

Or is it so simple? Even if we're to assume that Americans aren't about to shy away from their beloved T-bone steak and hamburger dinners, demand in the domestic corn feed market will fall regardless, because of the ban set by foreign importers. As illustrated, the export sector represents a significant portion of the beef market. Certainly, there should be concern that a reduction in corn consumption might result by whatever steps the livestock industry would normally take in response to an anticipated fall in consumption.

The market is accustomed to focusing on the flow of exports. The weekly commitment and inspection reports are often the biggest market movers. A crimp in the domestic market was a completely unexpected development. While long-term bulls clearly have ample grounds to feel somewhat smug about the market's response to the initial stage of the discovery of Mad Cow disease in the US, the potentially bearish issues will hang over the market in the foreseeable future.

The only mitigating factor that we can see at the moment is that countries that raise significant cattle for beef export, such as Australia and New Zealand, will see demand for their cattle products rise, and by extension, consumption for carbohydrate feed will increase.

Having reviewed the potential bearish implications, we should not lose sight of the fact that we came into the Mad Cow crisis with a basically bullish picture. The estimate for global output for 2003-04 was increased by just 200,000 tonnes in the December USDA supply/demand situation report. The estimate for demand, however, was raised by close to 3 million tonnes, which will result in a drop in ending stocks of over 2 million tonnes. Stocks as a percentages of consumption will fall to 11.7%, compared with 12.1% in the November report and 16% at the end of 2002-03.

Congress is working on energy legislation that is part of a trend to facilitate increased usage of ethanol as an alternative fuel source. Ethanol usage has been growing in the US. The USDA estimates that 1.1 billion bushels of corn were used for ethanol production this past year. As recently as the 2001-02 marketing year, US demand was only 714 million bushels. The USDA has not revised its 2003-04 estimate in many months, but recent data could be an indication that the 1.1-billion-bushel figure is due for an upwards revision. EIA data show that ethanol production in the US has been growing consistently this year. In November, output was 194,000 barrels per day, a 17% increase over November 2002. This could mean that US ending stocks are much tighter than the numbers we are working with.

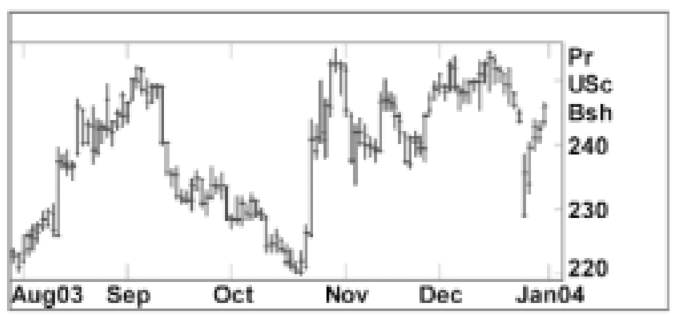
Finally, the all-important export sector is strong. As of last week's commitment report, sales of 25.3 million tonnes are running 29.5% over the same time last year. With China having all but closed its export market with the imposition of restrictive tariffs, the US is the only country that can feed the robust international demand we've seen emerge.

In conclusion, we'll need some time to see how much – if any – impact Mad Cow will have on corn consumption, but the general structure of the market remains bullish.

[January 2, 2004]

STRATEGY: *Stand aside.*

Chart 3 – March corn



Courtesy Reuters

COTTON

The bull is back

After cotton prices took a steep 26¢-per-pound plunge in November, we asked: "What happened to the bull market in cotton?" (see *Focus on Futures*, November 30). Well, participants have had time to absorb the bearish issues that caused prices to fall, and the market seems to have stabilized.

The fracas surrounding the tariffs that the Bush Administration slapped on Chinese textile-product imports to the US has quieted down. After the Chinese cancelled tours by purchasing groups in the days following the announcement of the tariffs, there were fears that the Chinese would retaliate by halting cotton purchases from the US. These fears have been alleviated to a large degree.

On December 18, Chinese and US government officials made a fairly big fuss about a deal in which the Chinese agreed to buy 2.5 million tonnes of soybeans from US exporters. There was a signing ceremony held at the Chicago Board of Trade, complete with champagne and media exposure. The amount of soybeans sold was actually less than the market was expecting. China had been buying soybeans all year long from the US without alcohol being served, but there seemed to a need for a symbolic, kiss-and-make-up gesture.

Although no date has been set, industry officials are optimistic that a tour by wheat purchasing groups early this year will follow. Because the tariffs were imposed specifically on cotton products, it is difficult to predict whether the Chinese will keep the squabble alive for cotton purchases. But the soybean splash was at the very least an indication that the aggressive move by the White House did not spark an all-out trade war with China.

Export commitment data show that China has been buying cotton in recent weeks, albeit in far smaller amounts than we saw earlier in the marketing year. This past week's commitment report showed that China bought 26,600 bales of cotton from the US, down considerably from purchases that were in the hundreds of thousands of bales in November. After the unlikely-to-be-repeated 1.2-million-bale purchase in late October, average weekly Chinese sales for November were 156,000 bales, compared with 62,000 bales in December.

Overall, though, sales are running far ahead of last year's pace. Commitments stand at 8.9 million bales, compared with 7 million bales last year at this time, an increase of 27%. With many months left to the 2003-04 marketing year, we are well on track to meet the USDA target of 13.2 million bales, which is a forecasted increase of only 11% ahead of 2002-03.

To underscore how vital strong exports are for this bull market to be maintained, consider the shift in consumption that has taken place in recent years. US mill consumption is in its sixth consecutive year of decline, while foreign consumption has shot up. Domestic usage in the US for the 2001-02 season was 7.7 million bales, but is estimated to reach only 6.2 million bales in the current marketing year. Foreign usage in 2001-02 was 86.9 million bales, but is forecast to climb to 91 million bales this year.

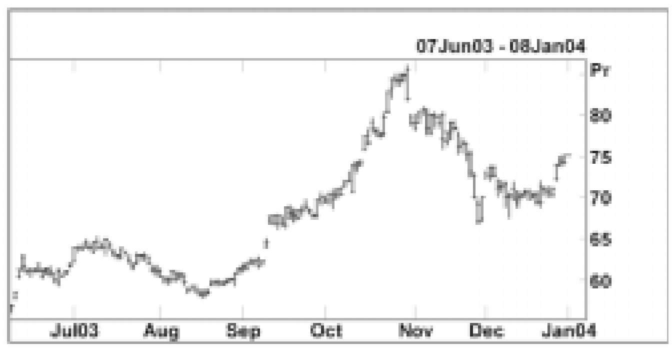
The December USDA supply/demand situation report lowered the estimate for global consumption by about 500,000 bales from its November report, which will result in an increase for the estimate of ending stocks by a similar amount. Stocks as a percentage of consumption will grow to 33.13% from 32.41% November. But these fresh statistics did not erase much of the very bullish gains seen in the November report, which saw ending stocks drop from 34.26%, so the bullmarket inventory level is still very much intact.

Another area we are watching to help us determine whether the bull run was a mere speculative bubble or whether it has the staying power to trade back to the highs – and perhaps beyond – is the activity of commercial traders *vis à vis* the speculative community. Although commodity funds still hold a sizeable net-long position of 18,500 contracts, that position has been reduced dramatically. When the market peaked in late October, the fund net-long position stood at 49,000 contracts. The market has now established a support level in the 70¢-per-pound neighborhood, with a price consolidation that has seen commercial traders emerge as eager buyers.

We remain long. We advise moderate-sized and therefore manageable positions for this relatively illiquid and volatile market. *[January 4, 2004]*

STRATEGY: *Remain long March cotton as per Flash Update of December 12. Maintain stops at 67.20, close only.*

Chart 4 – March cotton



Courtesy Reuters

HOTLINE UPDATE

Friday, November 28, 2003:
Good afternoon for Friday, November 28, 3:55 pm. The following is a recap of last week's trade recommendation history, and our latest recommendations and stop levels: On November 24, we covered our short December mini S&P position at 1051; on November 25, we rolled over our long December gold position into February, and liquidated our long March coffee position at 60.25; on November 26, we covered our short December Canadian dollar position at 76.25, and purchased March corn at 246.50.

We are currently long February gold at 391.30, with our stop at 375; long December Japanese yen at 9079, with our stop at 8980; and long March corn at 246.50, with our initial stop at 230. All stops are close only.

***Flash Update* – Wednesday, December 3, 2003:**
Good morning for Wednesday, December 3, 11:10 am. This is a Flash Update. We have purchased March cotton at 73.70, placing our initial stop at 67.20, close only.

***Flash Update* – Wednesday, December 3, 2003:**
Good afternoon for Wednesday, December 3, 5:05 pm. This is a Flash Update. We have sold short December mini S&P at 1065, placing our initial stop at 1090, close only. We repeat our update of earlier today where we purchased March cotton at 73.70, placing our initial stop at 67.20, close only.

Friday, December 5, 2003:
Good afternoon for Friday, December 5, 4:35 pm. The following is a recap of last week's trade recommendation history, and our latest recommendations and stop levels: On December 3, we purchased March cotton at 73.70, and sold short December mini S&P at 1065.

We are currently long February gold at 391.30, with our stop

HOTLINE UPDATE (continued)

at 375; long December Japanese yen at 9079, with our stop at 8980; long March corn at 246.50, with our stop at 230; long March cotton at 73.70, with our initial stop at 67.20; and short December mini S&P at 1065, with our initial stop at 1090. All stops are close only.

***Flash Update* – Wednesday, December 10, 2003:**
Good morning for Wednesday, December 10, 9:30 am. This is a Flash Update. We have rolled over our long December Japanese yen position into March, placing our initial stop at 8980, close only.

***Flash Update* – Thursday, December 11, 2003:**
Good morning for Thursday, December 11, 11:50 am. This is a Flash Update. We have rolled over our short December mini S&P into March, maintaining our stop at 1090, close only.

***Flash Update* – Thursday, December 11, 2003:**
Good afternoon for Thursday, December 11, 3:05 pm. This is a Flash Update. We have liquidated our long March cotton position at 69.30. We repeat our update of earlier today, where we rolled over our short December mini S&P into March, maintaining our stop at 1090, close only.

***Flash Update* – Friday, December 12, 2003:**
Good morning for Friday, December 12, 11:15 am. This is a Flash Update. We have purchased March cotton at 70.40, placing our initial stop at 67.20, close only.

Friday, December 12, 2003:
Good afternoon for Friday, December 12, 3:45 pm. The following is a recap of last week's trade recommendation history, and our latest recommendations and stop levels. On December 10, we rolled over our long December Japanese yen position into March; on December 11, we rolled over our short December mini S&P position into March, and liquidated our long March cotton position at 69.30; on December 12, we purchased March cotton at 70.40.

We are currently long February gold at 391.30, with our stop revised to 383; long March Japanese yen at 9171, with our initial stop at 8980; long March corn at 246.50, with our stop revised to 239; short March mini S&P at 1059.50, with our initial stop at 1090; and long March cotton at 70.40, with our initial stop at 67.20. All stops are close only.

***Flash Update* – Friday, December 19, 2003:**
Good morning for Friday, December 19, 11:40 am. This is a Flash Update. We have covered our short March mini S&P position at 1090.

***Flash Update* – Friday, December 19, 2003:**
Good afternoon for Friday, December 19, 2:15 pm. This is a Flash Update. We have purchased March wheat at 395.25, placing our initial stop at 375, close only. We repeat our Flash Update of earlier today where we covered our short March mini S&P position at 1090.

Friday, December 19, 2003:
Good afternoon for Friday, December 19, 3:30 pm. The following is a recap of last week's trade recommendation history, and our latest recommendations and stop levels. On December 19, we covered our short March mini S&P position at 1090, and purchased March wheat at 395.25.

We are currently long February gold at 391.30, with our stop at 383; long March Japanese yen at 9171, with our stop at 8980; long March corn at 246.50, with our stop at 239; long March cotton at 70.40, with our stop at 67.20; and long March wheat at 395.25, with our initial stop at 375. All stops are close only

***Flash Update* – Tuesday, December 23, 2003:**
Good afternoon for Tuesday, December 23, 2:50 pm. This is a Flash Update. We have liquidated our long March wheat position at 372.5.

***Flash Update* – Wednesday, December 24, 2003:**
Good afternoon for Wednesday, December 24, 1:00 pm. This is a Flash Update. We have liquidated our long March corn position at 233.75.

Friday, December 26, 2003:
Good afternoon for Friday, December 26, 1:50 pm. The following is a recap of last week's trade recommendation history, and our latest recommendations and stop levels: On Tuesday, December 23, we liquidated our long March wheat position at 372.5; on Wednesday, December 24, we liquidated our long March corn position at 233.75.

We are currently long February gold at 391.30, with our stop at 383; long March Japanese yen at 9171, with our stop at 8980; and long March cotton at 70.40, with our stop at 67.20. All stops are close only.

Friday, January 2, 2004:
Good afternoon for Friday, January 2, 4:10 pm. The following is a recap of our latest recommendations and stop levels: We are currently long February gold at 391.30, with our stop at 383; long March Japanese yen at 9171, with our stop at 8980; and long March cotton at 70.40, with our stop at 67.20. All stops are close only.

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