FRIEDBERG'S

FOCUS ON FUTURES

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Corn: bearish fundamentals but the damage seems to be done

The corn market has been on a steady diet of bearish news.

First and foremost, 2004-05 crop estimates for the world's biggest corn grower have increased throughout the growing and harvest seasons. The US grew a record crop of 298.23 million tonnes. This compares with last year's 256.9 million tonnes. The December USDA estimate was unchanged from November and reflects the completed harvest.

More recently, the discovery of rust on US soybean plantations means that, come spring, farmers who fear significant yield loss might favor planting corn over soybeans – where the choice exists.

While low prices may yet discourage massive 2005-06 corn plantings, the emergence of soybean rust certainly mitigates this potentially bullish factor for new crop corn.

On the global scene, China is expected to produce a bumper crop of 126 million tonnes, compared with 2003-04 output of 116 million tonnes. The production/consumption deficit will narrow to 7 million tonnes from last year's 13.5 million tonnes.

US exports – the single most important barometer of global demand – are sluggish. As of the most recent export commitment report, US exporters have contracted to sell only 21.54 million tonnes of corn. Last year at this juncture of the season, this figure stood at 23.63 million tonnes.

This is particularly troubling, because all current ending stock figures are based on the USDA's optimistic forecast for a fairly large increase in annual US exports, to 50.8 million tonnes, a 5.4% jump over the final tally for 2003-04. In its December supply/demand situation report, the USDA already trimmed its earlier, even more optimistic estimate for sales of 52.07 million tonnes. Unless there's a noticeable pickup in commitments, the USDA is likely to lower the 50.8-million-tonne figure again in its January report.

A closer look at the Chinese situation reveals that farmers may have enjoyed a fine harvest, but very little has been accomplished in terms of alleviating long-term concerns about feeding a growing and increasingly demanding population.

China grew similar size crops as far back as 1996-97, when output was 127.5 million tonnes. In 1998-99 and 1999-00 production reached 133 million tonnes and 128.1 million tonnes respectively. The big difference between now and those bumper-crop seasons, naturally, is that China was running substantial production/consumption surpluses in all of the years cited. But domestic demand has grown by about 2% per annum, and despite the improvement in this year's balance sheet, Chinese inventories are still being drawn down.

The USDA estimates 2004-05 ending stocks for China at 33.05 million tonnes, or 25% of consumption. This compares with 34% for 2003-04 and 52% in 2002-03. Chinese agricultural stock figures are notoriously inaccurate – they've been revised retroactively and dramatically twice in recent years. Based on what we're working with, though, it is fair to say that the robust corn crop that China grew this season has not altered the general feed-grain picture to any great degree. The Chinese are drawing down their inventories, which will keep them self sufficient in corn for the time being, but their export business will shrink from a record high of 15 million tonnes in 2003-03 and 7.5 million tonnes in 2003-04 to 4 million tonnes in 2004-05.

Commodity funds have enjoyed the ride down in corn prices with a large short position. As of this week's

Inside

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

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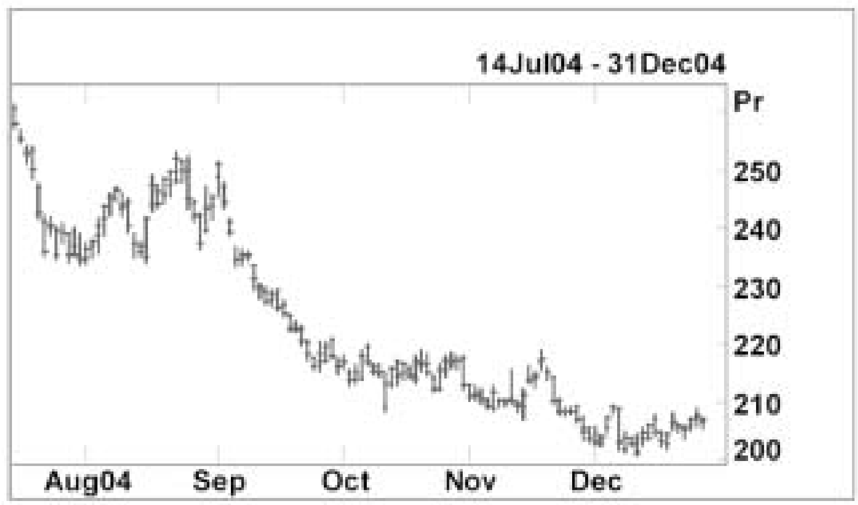
Commitment of Traders report, they still hold a 91,211-contract net-short position. Commercials have taken the long side. Over the past three weeks, however, the speculative short position has stopped growing.

Although we knew we were heading for a record US crop, the October USDA report provided the hard evidence with a 16.57-million-tonne increase over the September estimate, to 295 million tonnes. This estimate was published well before the completion of the harvest. Prices fell by as much as 25¢ per bushel, at one point, but are now less than 10¢ per bushel below where the market closed on the night before the release of the October report, even though the estimate has edged higher, to 298.23 million tonnes. Prices have already fallen from $3.35 per bushel in the spring of 2003. And it does seem that the funds have driven the market about as low as they are able or wish to.

We are not confident that the tight-supply environment has ended. Demand is growing worldwide, and it is unlikely that the recent slow pace of US exports is to become a permanent fixture of the corn market. It may require a lot of patience, but we believe the market is forming a long-term bottom. *[Dec. 29, 2004]*

STRATEGY: *Stay tuned.*

Chart 1 – March corn



Courtesy Reuters

WHEAT

Crops around the globe stage recovery

The global wheat market has turned the corner. After four consecutive years of production/consumption deficits, the 2004-05 marketing year will see an 11-million-tonne surplus. This compares with last season's 36.59-million-tonne *deficit*. Production is estimated to grow to 618.26 million tonnes, a substantial 66.87-million-tonne, or 12%, increase over 2003-04. Consumption is estimated to grow as well, but by a far more modest 18.44 million tonnes, or 3% above the previous season.

Global ending stocks will grow to 142.83 million tonnes, or 23.6% of consumption, up from 22.3% at the end of 2003-04, but still down from 2002-03 inventories of 27.9% of consumption. Just to put things in perspective, the average stocks-to-consumption ratio in the five-year period prior to the 2002-03 season was 34.4%. So we're not completely out of the woods.

There are two areas to keep an eye on that will determine price direction in the coming months: The progress of the recently planted US winter wheat crop and global demand.

We live in an era in which agricultural technology has allowed even Third World nations to increase crop size of various commodities by extraordinary amounts in short periods of time. It is a bit of an eyebrow raiser, then, when we consider that US wheat crop peaked in the 1981-82 season. The primary culprit is low prices. The 2002-03 crop was the smallest since 1970-71. That was followed by something of a reprieve in 2003-04 and 2004-05 when US crops improved to the levels of the 1990s. Still, it is quite clear that US farmers collectively are finding that planting wheat is not as profitable as the various alternatives.

Global reliance on US wheat imports is not nearly as significant as it is for corn and soybeans, particularly this marketing year when exporters and importers alike grew large crops. Aside from Australia, which experienced drought, the EU, the FSU, China, India, Argentina, and Canada all had much improved wheat crops in 2004-05.

Unlike corn and soybeans, for which the USDA estimates that US exports will comprise 66% and 43.8% of world trade respectively, US wheat exports are estimated to account for only 25.4% of world trade.

Still, the US remains the world's largest exporter of wheat (and retained that stature even in the 2002-03 season when US exports sank to their lowest level in 30 years). The health of the US winter wheat crop – which typically represents over 70% of the total US crop – must be monitored carefully. Although the global balance sheet improved, inventories have not changed very much – as illustrated above – from levels that caused a strong bull run in both 2002 and earlier this year (Chart 2). If demand were to increase unexpectedly or if other Northern Hemisphere winter wheat crops were to disappoint in the spring, the world would turn once again to the US.

According to the USDA, the 2005-06 US winter wheat crop got off to an excellent start. The final progress report of the seeding season released on November 29 showed the good-to-excellent portion of the crop at 76%, well above average. This report does not tell much about how much wheat was actually planted, though. We don't get a USDA acreage report until January. Current data seem to indicate that excessive wetness in many regions will result in actual seedings being a fair bit smaller than original intentions.

We've heard from several sources that farmers in Arkansas – where close to 1 million acres, or about 2% of the total US crop (spring and winter), are typically planted – were able to seed somewhere between only 100,000 and 150,000 acres. States further north, such as Ohio, Illinois, and Indiana, experienced similar wet conditions, and we can expect to see planted acreage lower in those regions as well.

Then there was a cold snap over the past few weeks, which reportedly caused some winterkill. The cold temperatures made for attention-grabbing headlines, but snowcover accompanied the falling mercury, which is beneficial for winter wheat as it heads into its dormancy stage. Nevertheless, it seems that there could have been some damage, and between this and smaller than anticipated plantings, the 2005-06 US crop is not off to a great start, despite the excellent crop rating it received on November 29.

Turning to the demand side, in its December supply/demand situation report, the USDA revised its estimate for 2004-05 US exports upwards by 680,000 tonnes, to 27.22 million tonnes, significantly below 2003-04 exports of 31.56 million tonnes. Current export commitment data are commensurate with the USDA estimate for lower exports this year. As of the December 23 export report, commitments stood at 20 million tonnes, compared with 22.5 million tonnes at the same time last year.

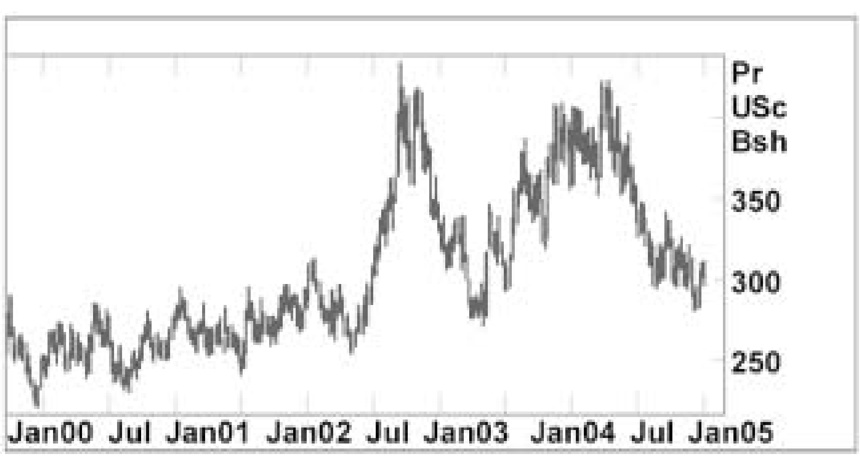
USDA data show that China has taken delivery of 1.9 million tonnes of the 2.03 million tonnes that it has contracted for, but this is a tad misleading and is not an indication of Chinese buying patterns for 2004-05. About 75% of those purchases were made early in 2004 when the Chinese trade delegation visited the US. The purchase was something of a political statement. China has purchased very little US wheat since the start of the marketing year on June 1.

In summary, the way things stand at the moment, the bumper crops grown around the globe should keep prices at bay for now. Nevertheless, with the market $1.5 per bushel from its highs, it is safe to say that the bear side has been properly represented.

The potential bullish factors are as follows: The market has not priced in a return to smaller US crops – that is, if the anecdotal evidence of inclement weather for the winter wheat crop pans out. Then there is China. Earlier this year it was believed that China would be a more active buyer of US wheat. After all, even with its 90-million-tonne crop, China still runs a production/consumption deficit. It could very well become a buyer later in the season. For the moment we remain sidelined. *[Dec. 30, 2004]*

STRATEGY: *Stay tuned.*

Chart 2 – Wheat, weekly nearest contract



Courtesy Reuters

SUGAR

Prices don't seem to want to go down

Sugar prices are trading at close to two-year highs. A cursory read of the open interest should send a shiver up the spines of bulls. The technically minded have been focusing on the record open interest and have thus been trying to fade the stubborn strength this market has displayed. The theory we've been working with in these reports is that a long-term price trend is sustainable – even with a bulging open interest – so long as open interest doesn't grow while prices stagnate. We have a system for monitoring the divergence, but its particulars are beyond the scope of this discussion. Suffice it to say that the pattern in the open interest over the past several months has flashed ample sell signals.

The market bottomed in February 2003 at about 5.5¢ per pound. At that time, open interest stood at 175,000 contracts and has grown by leaps and bounds as prices rallied by close to 4¢ per pound. Since the beginning of November, open interest has grown by 50,000 contracts, to 350,000 contracts, taking out the previous high of 330,000 contracts, which was set when prices touched 9.3¢ per pound in October. The conclusion should be that while the market has obviously not run out of new buyers, it has run out of quality buyers that have the strength to push the market beyond the highs.

A closer look at recent market action, however, reveals that during the first half of December, the market dipped and attempted to take out the previous, 8.3¢-per-pound, support level, but to no avail. Some weak longs, who worried about the potential of a large-scale liquidation by commodity funds that would drive prices down significantly, took the bait and lost their long position. Embarrassingly, this included us. Prices have snapped back, and March sugar closed out the month and the year at 9.04¢ per pound, a fresh, post-December-dip recovery high. Our conclusion: This market does not want to go down.

In last month's article on sugar we detailed how two consecutive years of disastrous crops in India will draw down its once burdensome inventory stockpile. To update the Indian situation, estimates for the 2004-05 crop have now slipped to 12 million tonnes, down from 13 million tonnes. Market analysts continue to insist that India will be buying only 1.5 to 2 million tonnes during the 2004-05 marketing year. We continue to find this estimate unrealistic, particularly in light of the fact that fresh estimates for 2004-05 ending stocks have been seen at 4.5 million tonnes, down from 8 million tonnes we wrote about last month.

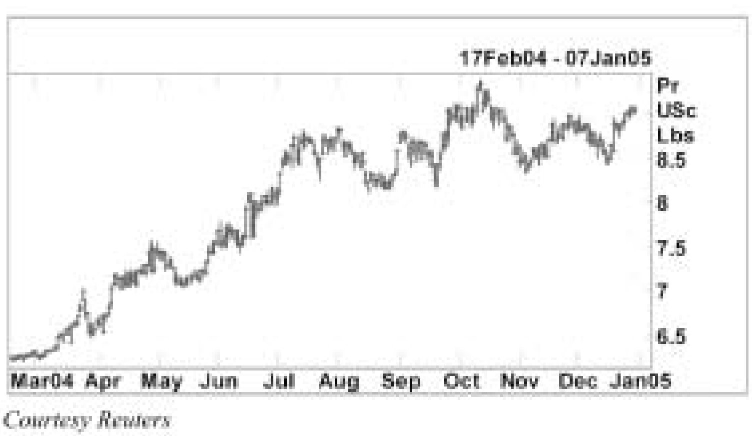
Contained in notes accompanying a December 21 report released by F.O. Licht on European crops is its rough estimate for the global production/consumption balance. It maintains that even recent forecasts for a deficit of between 3.4 and 4.8 million tonnes are overly pessimistic and that the deficit "could be considerably smaller." We certainly are not privy to the data gathering infrastructure that Licht has at its disposal. But when we combine the Indian situation, the rapid growth of the sugar-based ethanol market, and market action, we do not share Licht's confidence about shrinking deficits. We are crystal clear about the bullish fundamentals.

Getting back to the problem of the market being overbought in terms of the speculative community holding a massive long position, one has to feel confident enough about the potential for bona fide tightness to believe that the open interest matter can be resolved without the market going down.

Recent Commitment of Traders data indicate that this may be happening. Since early October – despite the explosive increase in open interest – the net-long position held by commodity funds has fallen from a peak of over 60,000 contracts to its current level of 29,000 contracts. This means that while the market has been churning in an 8.5¢-to-9.3¢ per pound range, with a lot of noise in the interim, the long position has been gradually changing hands from speculators to commercials. We find comfort in that and intend to re-establish a long position when the opportunity presents itself. *[Dec. 31, 2004]*

STRATEGY: *Stay tuned.*

Chart 3 – March sugar



Courtesy Reuters

COPPER

Any bull left?

Copper prices have enjoyed a fantastic bull run that has seen prices more than double over the past two years. The statistics that make the headlines seem to indicate that the market remains as tight as we've seen it in modern history, and by extension, that we are still riding a bull market. The International Copper Study Group's (ICSG) December data show that the January to September global production/consumption deficit of refined copper grew once again to 777,000 tonnes, up from 643,000 tonnes in the previous month's report.

Stocks in all three principal warehouse systems have fallen dramatically. At the LME, stocks stand at 50,000 tonnes, down from an early 2002 peak of 950,000 tonnes. COMEX stocks have tumbled to 50,000 tonnes from an early 2003 high of 400,000 tonnes. Shanghai stocks are down to 43,000 tonnes from a mid-2004 high of 140,000 tonnes.

Chinese imports have been the most important reason for the rise in copper prices. Chinese consumption has grown by an average of 8% over the past 2 years. Consumption growth in the other major consuming regions, for the most part, grew as well, but by more modest amounts. North American demand grew by an average 3.5% during the same period. Western European usage was stagnant while consumption in other Asian countries, including Japan, increased by an average of 5.3%. Obviously, the different growth rates in copper consumption reflect the varying levels of economic activity in the regions cited.

Because the demand side of the balance sheet of almost every commodity will be influenced by what happens in China, there is much debate over the sustainability of the economic boom in China. Industrial production is still humming along at a 15.7% year-over-year rate of growth and has fallen only marginally over the past several months.

We're not going to get involved in economic forecasting, but a closer look beyond the headlines seems to indicate that the bull may be running out of steam. After all the exciting statistics are digested, we should bear in mind that prices are very high in historical terms. While this may not matter very much to construction companies and government agencies that are building office towers and require raw materials to meet obligations and deadlines (more on that later), it will certainly manifest itself on the supply side.

After years of barely covering their cost of production, mining companies are extremely profitable at these price levels. The danger of creating a bear market with over-production is not first and foremost in their minds.

We needn't go further than taking a glance at what's been happening in Chile, the world's largest producer of copper. In 2003, mine output increased by 6.8%. ICSG estimates that 2004 output will grow by 9.7% over 2003. Since April, year-over-year monthly production increases have averaged 10.98%. For 2005, ICSG forecasts a 4.9% increase in Chilean mine production, but it is not a stretch to extrapolate from the activity of the last 3 quarters of 2004 that this estimate may be understated by a wide margin.

While prices were rising, global usage grew at a faster pace than production. Most copper market data have a significant lag time, and we suspect that more current information would show that the spread between supply growth and demand growth has narrowed. The ICSG report includes data only up until September. The futures market was inverted until early October. But the urgency of copper users seems to have abated.

Chart 4 shows that the March/May copper spread on COMEX has narrowed from a peak 7¢ per pound to the current 3.5¢ per pound. While changes in the inversion generally followed the direction of price, we find it intriguing that although the market made a new high just this week, the spread diverged and remained near its lows.

We don't want to stand in front of this train just yet, but we're looking to the short side. *[Dec. 31, 2004]*

STRATEGY: *Stay tuned.*

Chart 4 – March copper (top)/May spread (bottom)

Courtesy Reuters

HOTLINE UPDATE

***Flash Update* – Wednesday, December 8, 2004:**
Good afternoon for Wednesday, December 8, 3:10 pm. This is a Flash Update. We have covered our short March T-bond position at 113-03.

***Flash Update* – Friday, December 10, 2004:**
Good afternoon for Friday, December 10, 2:25 pm. This is a Flash Update. We have liquidated our long March cotton position at 42.30.

Friday, December 10, 2004:
Good afternoon for Friday, December 10, 4:10 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

- On December 8, we covered our short March T-bond position at 113-03. On December 10, we liquidated our long March cotton position at 42.30.
- We are currently long March sugar at 8.60, with our stop at 8.15; and long March cocoa at 1586, with our stop at 1525. All stops are close only.

***Flash Update* – Tuesday, December 14, 2004:**
Good afternoon for Tuesday, December 14, 2:15 pm. This is a Flash Update. We have liquidated our long March cocoa position at 1595.

***Flash Update* – Wednesday, December 15, 2004:**
Good morning for Wednesday, December 15, 9:30 pm. This is a Flash Update. We have liquidated our long March sugar position at 8.50.

Friday, December 17, 2004:
Good afternoon for Friday, December 17, 4:20 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

- On December 14, we liquidated our long March cocoa position at 1595. On December 15, we liquidated our long March sugar position at 8.50.
- We are currently holding no positions.

***Flash Update* – Monday, December 20, 2004:**
Good morning for Monday, December 20, 10:10 am. This is a Flash Update. We have purchased March cocoa at 1575, placing our initial stop at 1505, close only.

Thursday, December 23, 2004:
Good afternoon for Thursday, December 23, 4:30 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

- On December 20, we purchased March cocoa at 1575. We are currently long March cocoa at 1575, with our initial stop at 1505. All stops are close only.

***Flash Update* – Tuesday, December 28, 2004:**
Good morning for Tuesday, December 28, 10:45 am. This is a Flash Update. We have sold short March cotton at 43.26, placing our initial stop at 45.25, close only.

Friday, December 31, 2004:
Good afternoon for Friday, December 31, 3:45 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels.

- On December 28, we sold short March cotton at 43.26.
- We are currently long March cocoa at 1575, with our stop at 1505, and short March cotton at 43.26, with our initial stop at 45.25. All stops are close only.

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