FRIEDBERG'S
FOCUS ON FUTURES
Friedberg Mercantile Group Ltd.

Volume 8, No. 11 December 5, 2005

Ethanol demand keeps the sugar bull running

The relationship between the bull market in sugar and petroleum prices has been fairly well established. Sugar cane harvests in Brazil – the world's largest exporter of sugar – have grown steadily in recent years. To no avail, though, in terms of meeting the growing demand of the global sugar consumer. The ethanol/food production ratio has grown as well. With the cane harvest almost complete, it is estimated that 52% of the crop will be crushed into ethanol, up from 50% last year.

Current industry trends should keep that ratio growing. All gasoline used in Brazil must be blended with a minimum of 25% ethanol. Sales of so called "flex-fuel" cars, which can use any combination of gasoline and ethanol, represent more than half of all new car sales. Although ethanol prices have risen dramatically this year along with petroleum prices, they are still roughly half the price of gasoline at the pump.

Investment dollars are finding their way to this growing industry. Cosan, the world's largest sugar and ethanol production group, issued an IPO this month. There are approximately 300 privately held mills in Brazil, and analysts expect a significant trend towards consolidation.

Significant barriers exist to growth of widespread ethanol usage. Although an export market is taking shape in Brazil, the all-important US market will not be a significant factor anytime soon. The US maintains a prohibitive import tariff on Brazilian ethanol. Creative Brazilian exporters have successfully circumvented the red tape by shipping through other countries, but only for a limited amount.

The International Energy Agency threw a damper on things recently by estimating that even if the ethanol market were to continue to grow at the current, or even a quicker, pace, it would comprise no more than 10% of the global gasoline market by 2025.

Regardless, the strength in sugar prices is quite legitimate, because Brazilian exports make up close to 40% of global sugar trade. If the percentage of cane grown in Brazil continues to shift towards ethanol production, it affects the availability of sugar directly. Every tonne of cane diverted to ethanol is a tonne lost to world trade of sugar. There are virtually no other producing countries that can fill Brazil's role.

We are heading into a second consecutive year of global production/consumption deficits. Recently released estimates are optimistic that the balance sheet will show some improvement. All the major sugar analysts are forecasting that the global production/consumption deficit will shrink in the new marketing year. The International Sugar Organization is looking for just a small shortfall of 1 million tonnes, down from a 2004-05 deficit 3.17 million tonnes. E.D. & F. Man and Czarnikow estimate deficits of 2.3 million and 3 million tonnes, an improvement from drawdowns of 3.8 million and 3.94 million tonnes in 2004-05, respectively.

The size of the deficits is not overwhelming when viewed in a historical perspective and in terms of allegedly burdensome carryover stocks, although market action seems to be indicating otherwise.

As we've pointed out in the past, we are skeptical about the significance of those stocks. We do not believe that the existing inventories are ample or mobile enough to meet shortages. Brazil never has much sugar left after it's done with domestic consumption, exports, and of course, ethanol production. India has drawn its inventories down over the past two seasons because of disastrous crops.

Inside

Corn: Prices sinking, but bottom in sight 2
Copper: Are fundamentals bullish? 3
Soybeans: Foreign demand slumps 5

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

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

Get Focus by e-mail
Focus on Futures is available by e-mail as an Adobe PDF file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please send us a message at *focus@friedberg.ca* with your full name, e-mail address, and street address.

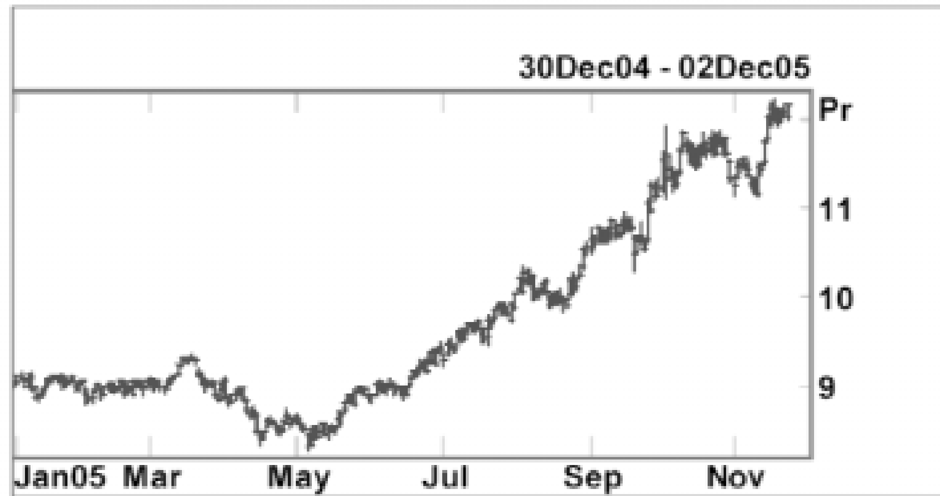
©2005 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

Speaking of India, we are expecting a recovery this season. So far, talk has been of a 17-million-tonne harvest, which is still shy of the crops it was growing before the droughts hit. With domestic consumption of 19 million tonnes, this means, of course, that India will not be able to replenish its warehouses and may have to resort to imports once again.

In conclusion, the size of the open interest has become a bit ridiculous, which raises the risk of a counter-trend correction. The bullish fundamentals that have driven this market are sound, however, and barring new developments, we would treat a sharp dip as a buying opportunity. If you're long, stay put.

[November 25, 2005]

Chart 1 – March sugar



CORN

Prices keep sinking, but there is a bottom in sight

Feeling the chill as we winterize our clothing and cars, it's easy to forget the scorching hot summer we left behind. At one point, the drought in the US Midwest threatened to reduce the 2005-06 corn crop by as much as 15% from the previous season's crop.

We learned a lot about agricultural technology this summer. Genetically enhanced seeds – which are used to grow a significant percentage of the US crop – left plants resilient enough to withstand the effects of the hot and dry weather. The USDA increased its estimate of the corn crop every month since August. The November estimate was raised to 11.032 billion bushels (bb), or 280.23 million tonnes (mt), compared with 10.857 bb (275.19 mt) in the October estimate and 10.35 bb (262.90 mt) at the height of the drought scare. The yield was cranked up to 148.4 bushels per acre (bpa), up from the previous month's estimate of 146.1 bpa, and well above the August estimate of 139 bpa.

It is premature to assume that yields are now in a perpetual uptrend because of the advanced crop wizardry and that crops are fully insulated from poor weather. It is particularly optimistic in the current environment in which natural gas prices have skyrocketed. The price of natural-gas-based fertilizer has almost doubled in price over the past year and the impact of this price increase is rather direct and can manifest it two ways.

To achieve optimum crop results in the coming summer, fertilizer is applied to corn fields in the fall to replenish lost nutrients to the soil. Understandably, many farmers are expected to pare back fertilizer use because of the cost, which should almost certainly result in lower yields.

Alternatively, farmers might devote more acreage to crops that require less fertilization.

Although fertilizer prices were already quite high in the fall of 2004, the incentive to plant corn was greater because corn prices were higher. But when the low price of corn and the high price of fertilizer are combined, there is virtually no profit in growing corn.

Despite the bullish implications of a smaller corn crop come next summer, corn prices – including new-crop months – are in freefall. Katrina backed up shipments for a while,

©2005 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

which caused a supply buildup of freshly harvested corn. The USDA is forecasting a sharp uptick in US exports in 2005-06, to 50.8 mt, compared with 46.08 mt last year. Shipments, however, are at virtually the same level as last year. Commitments are behind last year's pace but are picking up steam. As of this past week's export data, contracted sales stand at 18 mt, 7% behind last year at this time. That is an improvement from the start of November, though, when sales were 11.4% behind the same time last year.

Sales over the past couple of weeks were quite strong, and if they keep up, we should be able to meet the USDA target. After all, that forecast was based on demand patterns that were evident before the extraordinary events of the hurricane season wreaked havoc with the shipping infrastructure.

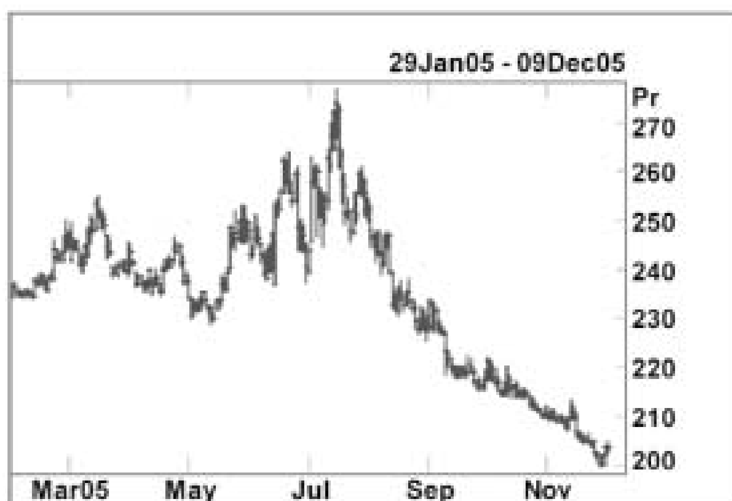
The issue of falling demand on account of bird flu has been prominent in the headlines and has appeared to pressure prices as well. Presumably, the matter involves the substitution of pork for poultry. A quote from a grain analyst in the November issue of *Price Perceptions*, however, lays such fears to rest: "...it requires 4.1 pounds of corn to produce a pound of pork compared to 1.8 pounds of corn to produce a pound of poultry."

We reiterate from previous discussions that the blockbuster US corn crop grown this past summer has done little to alleviate global tightness. Demand has grown, and the other significant producing countries grew smaller crops than the year before.

The USDA estimate for 2005-06 ending stocks is 16.69% of consumption, down from 18.55% in 2004-05.

We're close to a bottom. Accumulate long positions in new crop months. *[December 2, 2005]*

Chart 2 – March corn



COPPER

Are fundamentals as bullish as explosive prices suggest?

Copper prices continue to surge to all-time highs, with December currently trading at $2.17 per pound. While the bulk of available data supports this strength, we'll begin by saying that we maintain our position that the pure, long-term supply/demand fundamentals that involve mining and physical use of copper in industry do not support what has now become a 350% increase in price over the past 4 years (Chart 3).

This past summer, the long slide in LME warehouse stocks seemed to be ending, with a relatively modest rise to 80,000 tonnes, from 35,000. Modest, because LME stocks were at 1 million tonnes at the depths of the bear market. Those stocks have begun to inch up again and now stand at 73,000 tonnes, up from their recent dip to 60,000 tonnes (Chart 4).

In New York, however, there has been no movement, with warehouse stocks all but non-existent at 3,600 tonnes when compared with a peak of 400,000 tonnes in 2003 (Chart 5). With almost nothing to facilitate delivery, COMEX last week lowered the position limit in the delivery month to 250 contracts, compared with 3,000 contracts just over one year ago. This move by the exchange forced shorts to scramble for cover and added further steam to the rally.

While the move by the exchange was related to the supply/demand balance, another recent event that had little pertinence to fundamentals added even more fuel to the fire.

©2005 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

A trader working on behalf of China's State Reserves Bureau (although the relationship between the trader and the government arm is ambiguous) accumulated a massive – and obviously losing – short position. While the government tried to distance itself from the scandalous incident, it also took the unprecedented measure of assuring the market that it had ample reserves – 1.3 million tonnes – to deliver against the position if that were to become necessary. The significance of the fact that China has 1.3 million tonnes of copper seemed to slip by largely unnoticed. This *little* revelation takes at least some of the mystery out of The International Copper Study's (ICSG) monthly reports in which it has been carrying stocks of close to 1 million tonnes on its global balance sheet.

The short covering associated with the COMEX move and the anticipated short covering that should result from the Chinese trader's misguided trading are symptomatic of a blowoff. It is rather unlikely that the magnitude of the bullish fundamentals have taken on the urgency displayed by the huge leaps in price we're currently witnessing on a daily basis.

Chilean copper output continues to disappoint – the November 29 report of October activity showed production down 6.3%. Freeport McMoRan reports that its Indonesian operations are producing 5% below earlier expectations.

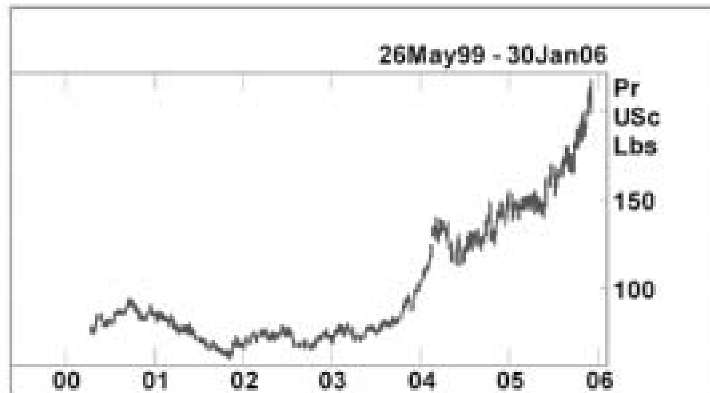
Despite the smorgasbord of bullish issues, the most recent ICSG report released on November 29 says that the global supply/demand deficit shrank in its January through August study period, to 114,000 tonnes, down from a shortfall of 235,000 tonnes reported last month. Consumption has been tapering off in all regions except for India and China.

Earlier in November, the ICSG forecasted a surplus for 2006 of 300,000 tonnes. It seemed a tad optimistic at the time. Now that we're as close to a balanced market as we've been all year, it seems a lot more believable.

The infrastructure is in place for output to recover. It is difficult to explain why Chilean production is so weak, but it is hard to imagine that these lofty price levels will not eventually provide the incentive to overproduce.

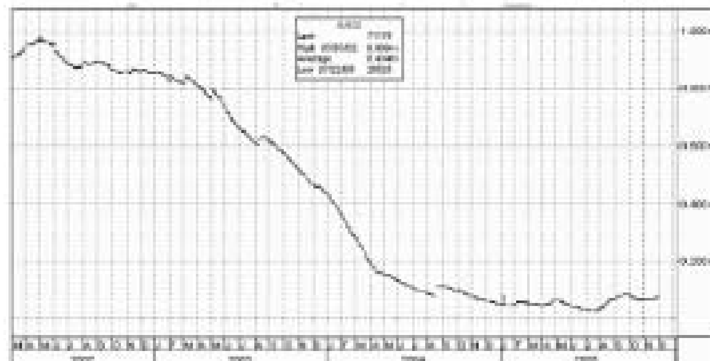
It is obviously ridiculous to try to short this market outright. A glance at the March/May spread on COMEX, however, shows that it has not moved very much since August (Chart 6). We therefore recommend selling March and buying May. A strong close above the high end of the range of the spread will indicate danger that the short covering is not over and that that level should be used as a stop loss. *[December 2, 2005]*

Chart 3 – Comex copper nearest contract



Courtesy Reuters

Chart 4 – LME copper warehouse stocks



Courtesy Bloomberg

©2005 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

Chart 5 – Comex copper warehouse stocks

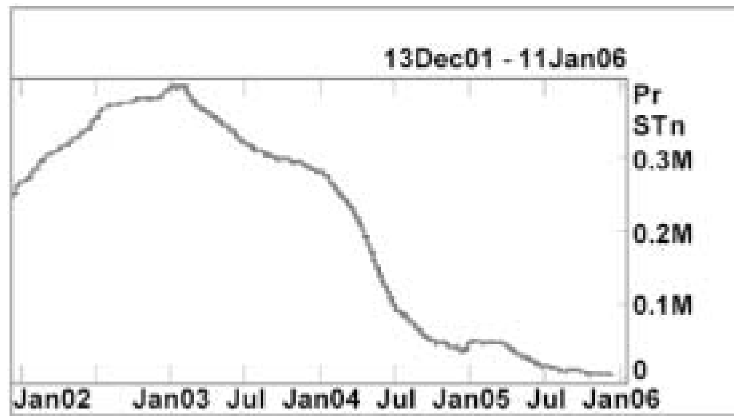
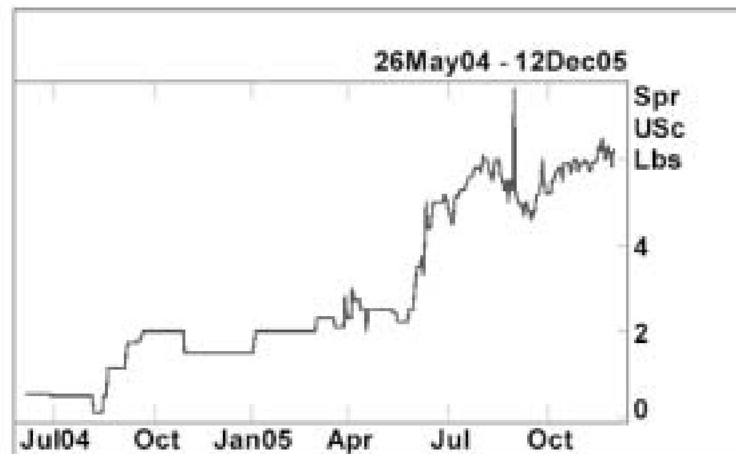


Chart 6 – March/May spread



SOYBEANS

Foreign demand slumps

A few months ago the USDA was predicting another season of record demand for US soybean exports. After all, Third World populations continue to grow, and increasingly modern economies will allow for more and better food. But as we head into the fourth month of the marketing year, things are not unfolding quite that way for US exporters.

Export commitments to date stand at 11.49 million tonnes, compared with 16.13 million tonnes at this time last year. Shipments of 7.56 million tonnes are behind last year's pace of 9.83 million tonnes. We can rationalize slow shipments because of the late start due to Katrina-related damage. The serious lag in new sales, however, means that purchasing planners are not anticipating the kind of demand we've seen last year.

In its November supply/demand situation report, the USDA responded to the situation by lowering its estimate for 2005-06 US exports to 29.26 million tonnes, down more than 1 million tonnes from its October estimate.

The outbreak of cases of bird flu in Asia certainly has had a strong influence on the market as traders assume that demand for soybean meal will fall if consumers shy away from poultry. As we pointed out in our November discussion on corn, however, some poultry demand will shift to pork demand, and hogs are fed protein as well. Regardless,

©2005 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

the numbers are quite clear, and they point to an overestimate of demand.

As it is, the global balance sheet is very much commensurate with the slide in prices we've seen. The US crop was revised sharply upwards in November, to 82.82 million tonnes, from the October estimate of 80.75 million tonnes. While the 2005-06 crop was well shy of the record 85-million-tonne crop harvested in 2004-05, it was an extraordinary crop nonetheless. Although US farmers planted 4% fewer acres in 2005-06 and experienced severe drought conditions for a good part of the summer, the crop was only 2.5% smaller than the 2004-05 crop. Farmers achieved record yields of 42.7 bushels per acre. Genetically modified plants proved to be hearty enough to withstand adverse climate conditions.

Global ending stocks for 2005-06 are estimated at 46.75 million tonnes, or 21.6% of consumption, compared with last season's 20.42% and 18.52% in 2003-04. This will be the second consecutive year in which global supply will exceed demand and allow inventories to be replenished to more comfortable levels.

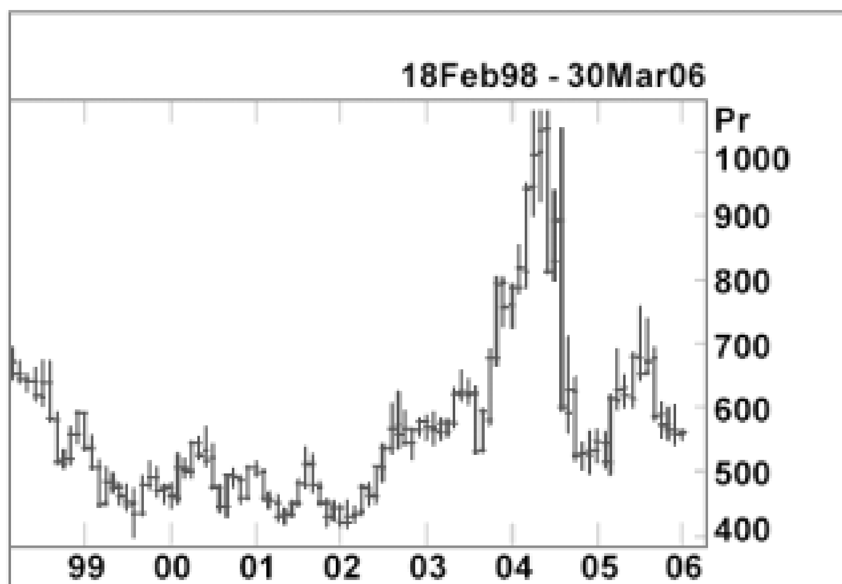
There is one fly in the ointment for the mostly bearish case presented thus far, and that is Brazil. In November, as expected, the USDA lowered its estimate for Brazilian output to 58.5 million tonnes, from 60 million tonnes in October. The *déjà vu* feeling is unmistakable. Brazil has yet to prove that it can grow a crop any larger than 51 million tonnes. As we documented in *Focus on Futures* earlier this year (May 24 and July 29), a pattern has emerged in each of the past several years where analysts start the Brazilian crop with estimates of well over 60 million tonnes only to be disappointed. It's no small matter when we project carryover stocks early in the season that are off by more than 10 million tonnes! Perhaps this year Brazil will come through.

In any case, despite the steep slide in prices that began early this summer, there is no compelling reason to buy soybeans. On the other hand, we have little interest in being short a commodity that was double in price 18 months ago and whose bear market we missed out on completely. It is hard to see how the US can catch up on exports, but at least we know what to watch for.

In conclusion, if exports do indeed recover and/or if the Brazilian crop begins to look as if it is headed for a repeat performance, we will become interested in the long side.

[December 2, 2005]

Chart 7 – Nearest contract soybeans



Friedberg's Focus on Futures is published by Friedberg Mercantile Group Ltd., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3. Contents copyright © 2005 by Friedberg Mercantile Group Ltd. All rights reserved. Reproduction in whole or in part without permission is prohibited. Brief extracts may be made with due acknowledgement. Friedberg Commodity Management Inc., an NFA registered CTA, takes full responsibility for the contents of this publication.

Subscription Enquiries for
Friedberg's Focus on Futures
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
416-364-1171

All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group Ltd.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada M5J 2T3
1-800-461-2700

All statements made herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate.
Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.