FRIEDBERG'S
FOCUS ON FUTURES

Friedberg Mercantile Group Ltd. Volume 10, No. 11 December 13, 2007

Wheat: the bull is back

In itself, the title of the November 12 issue of *Focus on Futures* – "An Aging Bull" – was a fairly clear statement of where we stood on the matter of the future direction of wheat prices. We argued that far out-of-sight prices had taken the wheat market through the rationing process, spurred by a wave of desperate purchases by importing countries. Buyers had obviously gone overboard, because US exports came to an abrupt halt, which explained the sharp setback in prices (Chart 1).

Further calming the market's fears of supply shortages was the outlook for the future. Forecasts for higher Northern Hemisphere winter wheat acreage were beginning to surface. The planting season for the 2008-09 US winter wheat crop went very well. Wheat prices at over $9 per bushel began to look a little ridiculous. Even new-crop prices, which were trading more than $2 per bushel below the spot, were still very rich in historical terms. In addition, Southern Hemisphere producers were only a couple of months from shipping their crops. By mid-November, the market was becoming comfortable with the notion that the worst was over.

The comfort zone didn't last very long. Adverse weather developments in both the Northern and Southern Hemispheres ended the calm.

Some areas in Argentina experienced two frosts a couple of days apart that reportedly caused some crop damage. The market rallied for a few days, but the weather stabilized and March wheat continued to make new lows for the move. On November 22 Argentina's agriculture ministry released a report that said the excellent soil moisture during the growing season countered the effects of the frost and raised its estimate for the crop to 15.4 million tonnes, which was slightly above its previous estimate. In fact, the estimate was old hat, because the USDA had already raised its Argentinean estimate in its November supply/demand situation report by 1 million tonnes, to 15.5 million tonnes.

All might have been well except for the fact that over the past couple of days talk has emerged that Argentina's revised crop estimate obviously did not account for the impact of the frost, and some analysts are saying that losses may have reached as high as 2 million tonnes.

In addition, the weather for the early development of the US winter wheat crop went dry. New crop prices, which had traded in a very narrow band (Chart 2) since September – awaiting the progress of the crop that was going into the ground – broke out sharply.

Without spelling it out, the Argentinean government confirmed that its November 22 estimate was based on pre-frost surveys. On November 28 the ministry announced that export registrations would be closed for five working days, which gives it a chance to assess the amount of losses and ensure that enough wheat stays in Argentina to meet domestic needs before the export market is seen to.

A 2-million-tonne drop in Argentinean exportable surplus will pull 2007-08 global ending stocks back down to 17.48% of consumption, just a hair above where forecasts were when the market was trading above $9 per bushel.

Early forecasts for the 2008-09 global wheat crop are calling for an increase of about 7%, which would provide an absolutely vital production/consumption surplus that would allow depleted stockpiles to grow. Poor weather in the US winter wheat belt does not necessarily throw the entire recovery into jeopardy. It does, however, expose the

Inside

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.

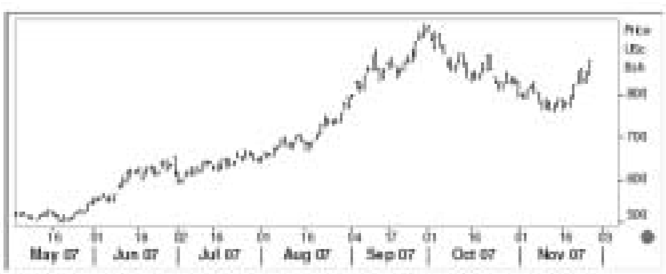
Get Focus by e-mail
Focus on Futures is available by e-mail as an Adobe PDF file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please send us a message at *focus@friedberg.ca* with your full name, e-mail address, and street address.

vulnerability of this market.

We have switched from declaring an end to the bull market to recommending a long position in new-crop months. Buy July CBOT wheat. Alternatively, buy July Kansas City Board of Trade wheat (Chart 3), which reflects developments in the winter wheat crop more accurately, but is a relatively thin and illiquid market. Initially, the correct stop is a close below the bottom of the 3-month range. Beware, however, that is very far away and represents substantial risk.

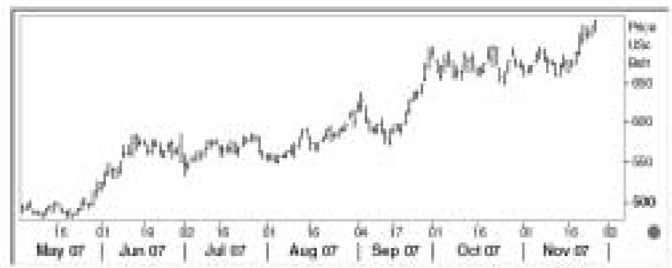
[November 29, 2007]

Chart 1 – March CBOT wheat



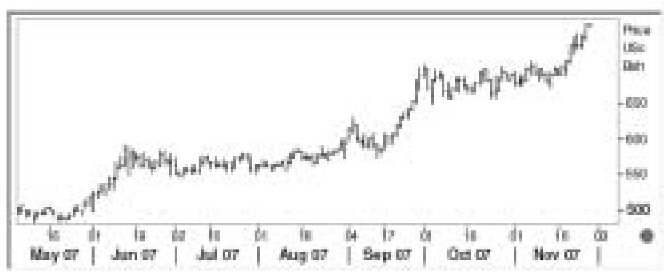
Source: Reuters

Chart 2 – July CBOT wheat



Source: Reuters

Chart 3 – July KCBT wheat



Source: Reuters

COTTON

Higher prices need to bring out more acres

The November USDA supply/demand situation contained significant bearish revisions to both the production and consumption sides of the 2007-08 US balance sheet. The estimate for output was increased by a not insignificant 710,000 bales, while the forecast for exports were lowered by 500,000 bales, also a substantial amount.

The export figure was reduced to reflect the flow of weekly export commitments. While sales are fairly steady, we've slipped behind the pace necessary to meet the USDA's rather optimistic October forecast for the season of 16.7 million bales, up from 13.2 million bales in 2006-07. Although we're still far ahead of last year at this time, consider that on November 1, commitments were 51% in front of 2006-07, but as of November 29, they've fallen back to only 35% ahead of last year's sales.

The upwards revision in US output in November was the result of a 33-pound-per-acre increase in the yield estimate from the October estimate, to a record 859 pounds. It was the second consecutive upwards revision in yields as the weather improved in the late growing stages.

The issue of declining acreage, however, has dominated the cotton market, and we expect that to continue. The primary reason for the rally that took March cotton to over 70¢ per pound earlier this year (Chart 4) was the 29% drop in 2007-08 US cotton area. The late spurt in cotton yields does shore up the US balance sheet, but will not have any long term-effect on this market.

Back in the October USDA report, there was a massive rise in global ending stocks, from 40.35% of consumption to 42.4%, which was the result of one of those "discoveries" of 3.5 million bales of cotton tacked on to the 2006-07 Chinese crop. Whatever.

But despite the bearish revisions to the US picture in the November report, the overall global balance sheet was little changed, because a sharp, 1.25-million-bale drop in the estimate for Pakistani output balanced out the US revisions, which keeps global stocks at 42.4% of consumption.

Charts 5 and 6 illustrate how cotton prices have declined *vis-à-vis* the other major US crop prices over the years, particularly against soybeans and wheat. Cotton prices will have to rise significantly as we head towards the planting season next spring to inspire farmers to increase cotton acreage.

Even though Chinese production jumped over the past two seasons in response to growing demand, its production/consumption gap grew from 15 million bales in 2005-06 and 2006-07 to 19.5 million bales in 2007-08. US export commitments to China so far this season stand at 1.7 million bales, compared with just under 900,000 bales at the same time last season. We can expect Chinese purchases to gain momentum.

Cotton acreage in the US for certain – and very likely in all multi-agriculture producing regions – is in a perpetual decline. A possible analogy can be drawn to the wheat market where we saw world production stagnate for years while farmers planted more profitable crops. When prices finally began to rise and acreage was increased, it was too little too late. The acute vulnerability of the situation was exposed with crop failures, which eventually saw wheat prices more than triple.

The supply side of cotton is equally vulnerable.

Cotton is in the early stages of a bull market, which – most recently – saw a sharp pullback accompanied by a healthy washout of open interest (Chart 7).

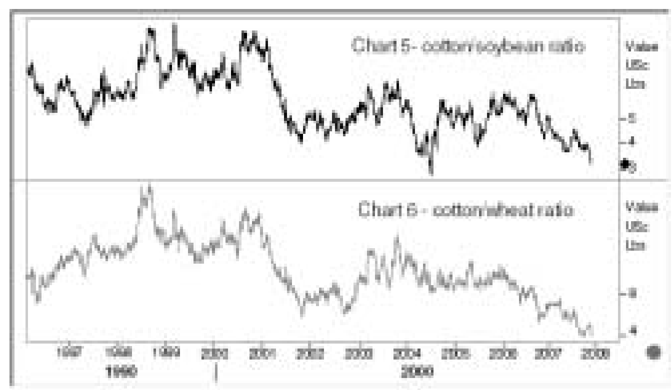
We recommend accumulating conservative long positions in this relatively thin and illiquid market.

[December 6, 2007]

Chart 4 – March cotton

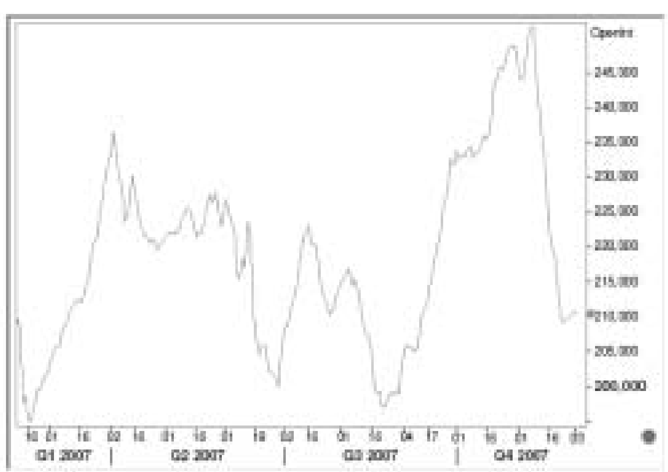
Source: Reuters

Chart 5 – Cotton/soybean ratio / Chart 6 – Cotton/wheat ratio



Source: Reuters

Chart 7 – Cotton open interest



Source: Reuters

CORN

Can corn stand on its own?

Corn prices have rallied smartly since late-summer (Chart 8) and are not far behind the $4.37-per-bushel peak set back in March. One can't help, however, but feel that the strength has been more of a tag-along to beans and wheat rather than a move rooted in the corn market's own bullish supply/demand fundamentals. To illustrate the point, consider that the first estimate of ending stocks released in May for the 2007-08 US and global ending stocks was for 24 million tonnes and 90 million tonnes, or 9% and 11.70% of consumption, respectively. The November estimate of those inventories grew to 18.52% and 14.47% of usage! A swing from near-historic lows to a relatively well supplied market.

While US exports turned out to be better than expected early on in the season, the USDA underestimated acreage and yield, and by the time the harvest was complete, the crop was more than 5% larger than the first forecast. Increased US output was the biggest contributor in beefing up the balance sheet.

The other important factor in the dramatic improvement of the balance sheet was the overestimation of how much US corn would be used for ethanol. The estimate for 2006-07 and 2007-08 combined dropped by close to 6 million tonnes over the past few months. Given current ethanol usage trends, the USDA is probably still too optimistic with its forecast for 2007-08 usage at 81.2 million tonnes. This figure assumes a 52% increase in corn-to-ethanol conversion, while actual government consumption data for the US show that ethanol usage is growing by only 38% – that's a difference of about 7.5 million tonnes of corn.

Although recent history has been somewhat of a disappointment for ethanol consumption in the US, the market will continue to grow as its commercial viability increases, especially if petroleum prices remain strong.

Looking ahead, the situation is generally bullish. The mere fact that wheat and soybean prices have outperformed corn prices by such a wide margin (Charts 9 and 10) in itself can prove to be very bullish, because we are certain to see a significant shift away from corn acres to wheat and soybean acres when planting gets underway in the spring. A smaller crop makes output all the more vulnerable to inclement weather.

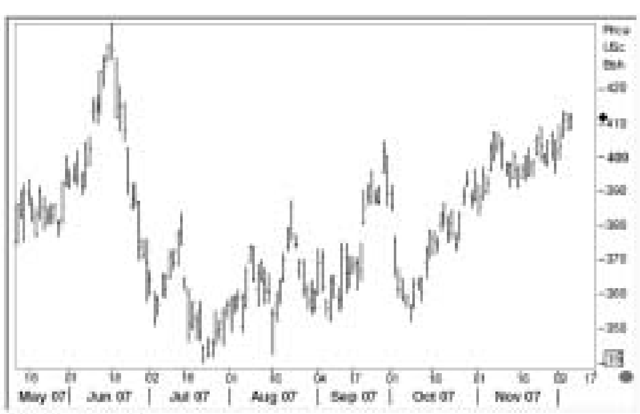
It is extremely early for acreage estimates. Informa Economics has already weighed in with its second 2008-09 US corn acreage forecast, at 88.9 million acres, up from its first estimate of 85.8 million acres. This compares with 93.6 million acres planted in 2007-08. The upwardly revised estimate is presumably on account of the rally. But, as we can see clearly from Charts 9 and 10, the multi-month rally in corn prices has done little to improve the prospects of "stealing" acres from wheat and soybeans because they've been even stronger, leaving corn prices near multi-year lows in terms of the others.

Another bright spot is the demand side. US exports have been quite robust. The USDA is forecasting record 2007-08 sales of 59.69 million tonnes, 10.6% higher than last season. Commitments are way out in front of that pace at 35.4 million tonnes, 36% ahead of last year at this time. It would be difficult to assign the "panic buying" explanation – similar to what's been happening with wheat – because there's been nothing to panic about. Supplies have been ample, with the crop freshly harvested and prices not running away.

For the moment, we are going to stick with the theory that corn piggybacked on wheat and beans. The bullish potential at this time is exactly that – potential. Acreage will, of course, be a huge factor, but we are many months from any accurate assessment. The market would probably suffer a serious setback if the export pace were to letup because that would just mean that the 2007-08 US balance sheet would return to average levels of the past 10 years, which makes $4-per-bushel corn unsustainable.

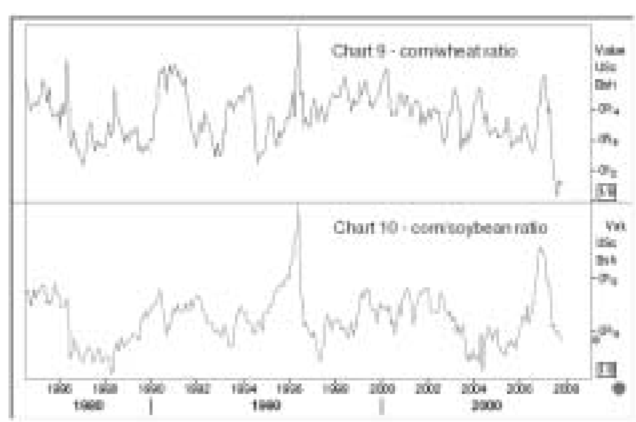
Stand aside. *[December 7, 2007]*

Chart 8 – March corn



Source: Reuters

Chart 9 – Corn/wheat ratio / Chart 10 – Corn/soybean ratio



Source: Reuters

COPPER

Correcting the bull or bringing on the bear?

Copper prices tumbled by more than 20% over the past two months (Chart 11). While there's definitely been several copper-specific bearish developments, an examination of the indicators that we follow do not necessarily provide any clear direction.

Probably the most influential – non-copper related – factor was a renewed round of subprime/recession fears. Chart 11 shows a very close relationship between the movement in copper prices and the Dow Jones Industrial Average. The correlation is not perfect, but over time it is quite clear that these markets are very likely responding to the same stimuli – justified or not.

The market has focused on the rise in LME warehouse stocks that began in July (Chart 12). However, the combined global total, which includes the other two principal exchange warehouses at the COMEX and Shanghai, has really not moved very much (Chart 13). The drop in price has been accompanied by a jump in total stocks of about 30,000 tonnes, to 233,000 tonnes, but we're still well below the 285,000-tonne level reached earlier this year.

Production in Chile – by far the world's largest copper miner – remains a disappointment. On September 26 the IMF published a report that forecast Chilean copper production in the near term to grow at 3% per annum. In September, Chilean output jumped 21% over a year ago, and that headline attracted some attention. But it was an anomaly, because output in September 2006 was very small. Excluding September, the average rate of growth since April has been only 1.4%.

The November International Copper Study Group (ICSG) report supported the sharp drop in prices. The report showed that the global production/consumption deficit shrank in the January-through-April study period to 258,000 tonnes, down 60,000 tonnes from the previous month. Demand was constant, still running 7.5% ahead of the same period in 2006. Although the production pace continued to lag usage, global refined production picked up a notch, now growing by 4.9% over last year, compared with 4.5% in the October report.

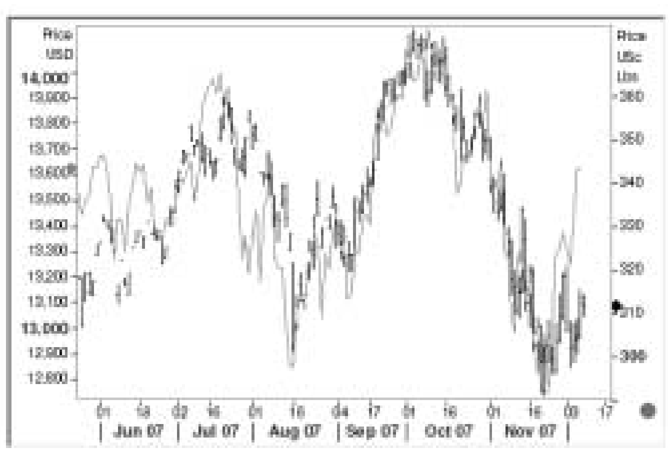
The crux of the bullish argument is that China is in a state of perpetual economic growth, and even a slowdown in the US and Europe should sustain demand for industrial commodities. India is often overlooked in this discussion, but it too has a population of over 1 billion people and is also in a state of modernization that should see usage of industrial commodities grow regardless of economic conditions in the West. India is currently a net exporter of about 100,000 tonnes of copper, but analysts expect it to become a net importer over the next several years. Specifically, the electric power infrastructure is in dire need of repair and growth if India is to meet the needs of rapidly expanding manufacturing industries and an increase in modern buildings. Power shortages resulting in blackouts are currently commonplace.

The supply/demand fundamentals, which have allegedly shifted to the bearish side over the past couple of months, consist mainly of rising warehouse stocks, which – as we illustrated – are merely moving around in a relatively tight range. The data in the ICSG report that reduce the deficit are three months behind, and the more recent data, such as Chilean production, indicate that we have probably not moved much closer to a balanced market since August.

In conclusion, the direction of copper prices is likely to continue to be dictated by the whims of the stock market, regardless of developments in actual copper fundamentals. The Commitment of Trader's data show that commodity funds have built a net-short position, and with bullish sentiment readings at 52-week lows, it would seem that a short-covering rally is a distinct possibility. That's for the short-term, and we're not uncomfortable recommending a long position, with a good-anytime stop at the lows of the nearby contract. For the longer term, it is vital to watch the various available indicators to determine whether the drop in the global deficit is the start of a trend or not.

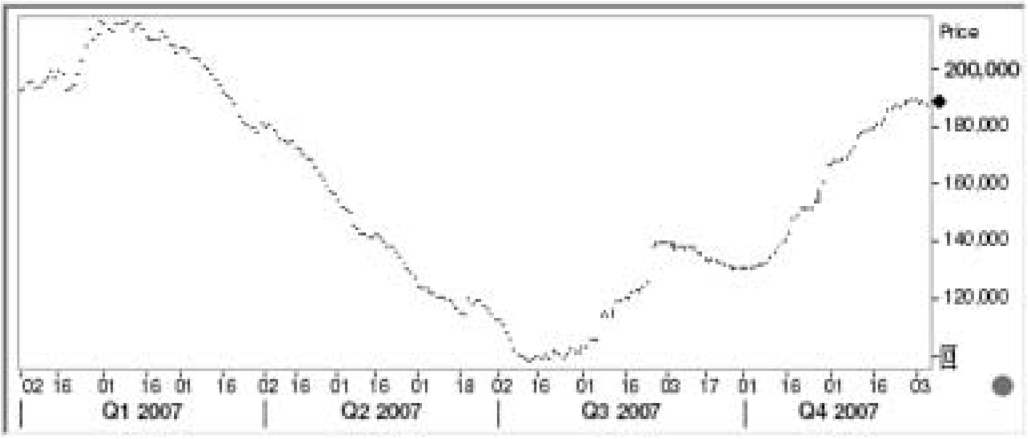
[December 10, 2007]

Chart 11 – March copper



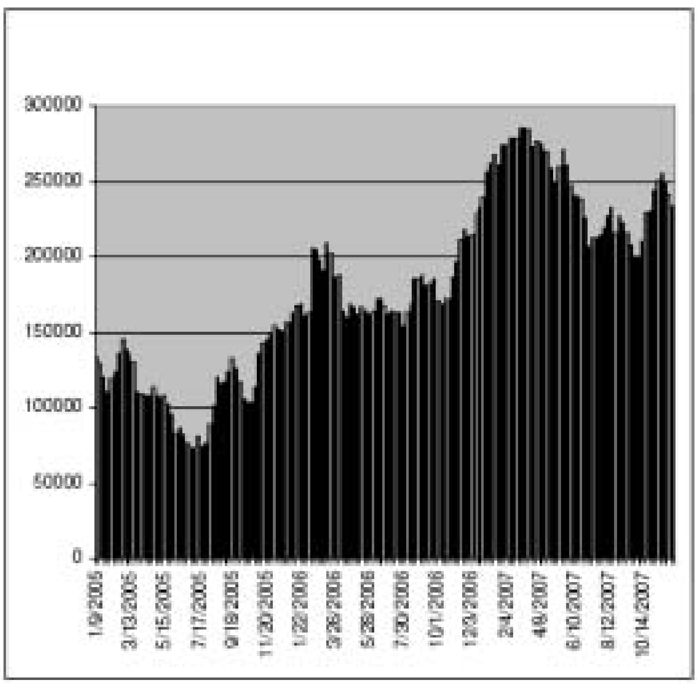
Source: Reuters

Chart 12 – LME warehouse stocks



Source: Reuters

Chart 13 – Global warehouse stocks



Source: Reuters

Friedberg's Focus on Futures is published by Friedberg Mercantile Group Ltd., P.O. Box 866, Suite 250, 181 Bay Street, Toronto, Ontario, M5J 2T3.

Subscription Enquiries for
Friedberg's Focus on Futures
Suite 250
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
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

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