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## FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 11, No. 10 December 2, 2008

## Have copper prices found a bottom?

The most pertinent fundamental of commodity markets in the current environment is the anticipation of continued demand destruction. The documentation of other factors has become unfashionable and dismissed as an exercise in futility. Even where bullish supply factors would normally be extraordinary, markets are overwhelmed both by the possibility of shrinking consumption as well as by general asset liquidation. Still, it is necessary to keep track of all supply/demand issues, because there will be a day when they matter once again.

Copper usage is obviously highly sensitive to economic activity. Chart 1 shows that prices have plummeted by more than \$2.50 per pound since early July, when they spiked to over \$4.

US economic indicators have been downright frightening. With tumbling housing data and skyrocketing jobless numbers, a sharp drop in demand for industrial commodities can't be far behind.

Warehouse movements have been consistent with falling consumption. Combined stocks at the LME, COMEX, and Shanghai have increased steadily since July and are now at levels not seen since early 2007, just before commodity prices were ready to explode (Chart 2). The hard consumption numbers, however, paint a somewhat different picture.

Cumulative global copper usage was weak in the first half of the year, but has now begun to show a counter-seasonal trend, with year-over-year gains over the past several months. The International Copper Study Group's (ICSG) most recent report – released on November 21 – shows that in its January through August study period, refined copper usage was 12.15 million tonnes, up 2.5% over the same period in 2007. The ICSG data have a significant lag period.

The less widely watched London-based World Bureau of Metal Statistics (WBMS) publishes more timely data, which show that usage was still 1.5% higher over last year in its January-to-September study period. In fact, according to the WBMS, year-over-year usage hit a low back in June, when the comparative January to June period was down 2.5% over 2007, but has been climbing since. Not something bears want to hear.

Both statisticians have estimated that global mine production is running about 1.5% behind last year. This is

mainly on account of continued problems with Chilean production. So far this year, production has been below year-ago levels in all but two months. Through September, average monthly production has been down 2.9% in 2008. The global balance sheet is now running a year-to-date surplus, but ICSG expects that surplus will reach only 100,000 tonnes for 2008.

The strategy we recommended back in August – bear spreads – was profitable, but only marginally so when compared with outright shorts. Chart 3 shows that the trade may have run its course, and as we illustrated, the argument of ample availability is not commensurate with developments on either the supply or demand sides.

There is a certain unspoken assumption that the bear market in commodities must end with prices back at pre-bull-market levels. This could very well be true for some markets, especially if they had no business being up where they were in the first place. In other markets, however, production growth did not respond to an expanding global populace and modernizing Third World economies. If economies around the world begin to respond to all the financial stimulus being thrown around sooner than expected, the copper output infrastructure could not handle demand in its current state.

We recommend covering any short positions.

[November 24, 2008]

### Inside

<b>Cocoa:</b> Poor Ivory Coast crop supports bull story .....	2
<b>Corn:</b> Sinking demand .....	4
<b>Wheat:</b> Problem solved? .....	5

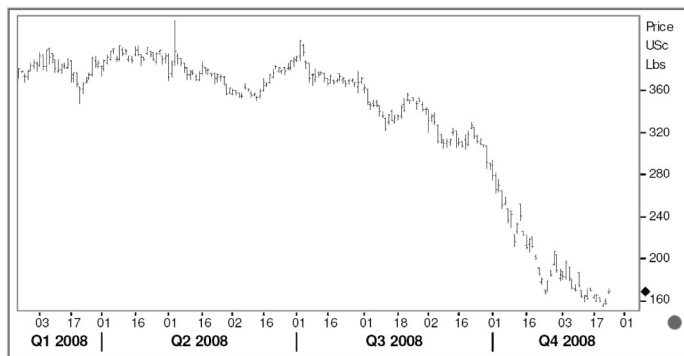
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Chart 1 – Nearest contract copper



Courtesy: Reuters

Chart 2 – Global warehouse stocks

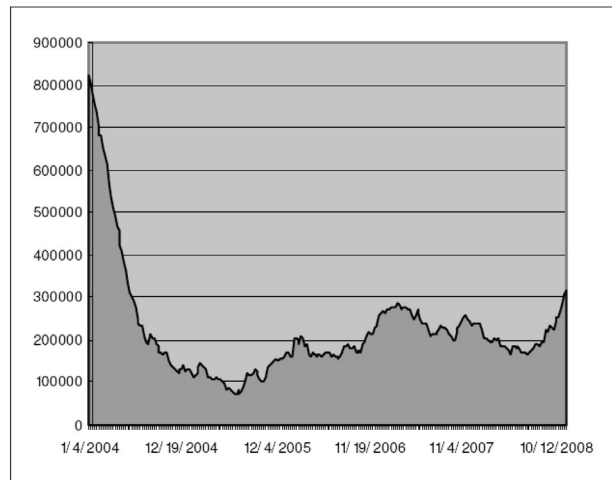
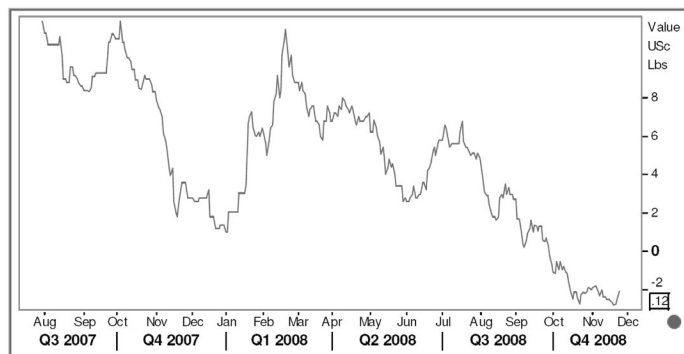


Chart 3 – March/July copper spread



Courtesy Reuters

## **COCOA**

# Is demand weak enough to mitigate a miserable Ivorian crop?

The price for many commodities dropped to fresh lows in the past several days, to levels that date back to the pre-bull-market days. Cocoa prices tested their lows earlier this month, but bounced off short- and long-term support levels, and are now about \$250 per tonne, or more than 10%, above the intra-day low touched on October 24 (Chart 4).

The early part of the 2008-09 Ivorian harvest season, which began in October, has been something of a disaster. Two months into the marketing year, port arrivals stand at 201,000 tonnes, down from 398,000 tonnes at this time last year. In fact, the difference between this season and last is really larger, because last season the harvest began early, and a substantial amount of beans was counted into the 2006-07 marketing year tally.

Local analysts are estimating that the total crop – the main-crop, which is harvested through early spring, plus the secondary mid-crop, which runs through until September – will be no larger than 1 million tonnes, down from last year's 1.36 million tonnes. While using the early results makes this forecast seem quite plausible, we should

take into account that it is premature to predict that the arrival rate will not pick up.

In any case, it is reasonable to assume that the Ivorian crop will be below average. One of the issues that the industry in the Ivory Coast is grappling with is farmer compensation. Earlier this year, the government raised the export tax to 46% – exorbitant by industry standards. Farmers, in turn, are paid a much smaller percentage of the prevailing world price that exporters receive. As a result, less money makes its way to pesticides and other crop inputs, leading to due-course poor yields as well as an ever-increasing incidence of disease.

A brief overview of other key producing regions shows that they will not be able to compensate for any shortfalls generated by the Ivory Coast.

Nigeria should see an improved crop this season. First, weather has been much more favorable. In addition, the government embarked on an ambitious program years ago to increase cocoa output, and that initiative is starting to show some success. Trees that were beneficiaries of more advanced pesticides and disease-resistant seeds now produce fruit in

less than two years, which is down from the historical norm of up to five years. Although government agencies have been claiming crops of up to 500,000 tonnes, independent analysts put output in the 300,000-tonne area and agree that production could be up as much as 15% in the current season. Still, this would amount to an increase of 40,000 tonnes at best, which is dwarfed by the potential drop in output in the Ivory Coast.

The Ivory Coast's neighbor, Ghana, has experienced the same poor patterns. Early arrival levels have been down even more than those in the Ivory Coast, so we cannot expect Ghana to fill the void.

Indonesia continues to struggle to maintain output levels. A disease that is relatively new to cocoa plantations – vascular-streak dieback – has further impeded output.

As far as demand is concerned, the two indicators that we watch are bearish. Butter ratios have slipped, particularly in Asia (Chart 5).

Third-quarter grind results were poor as well. For the first time in as long as anyone can remember, the German cocoa grind was down – by 16.6%. This compares with an average increase of 15% in the previous two quarters.

The International Cocoa Organization (ICCO) is there-

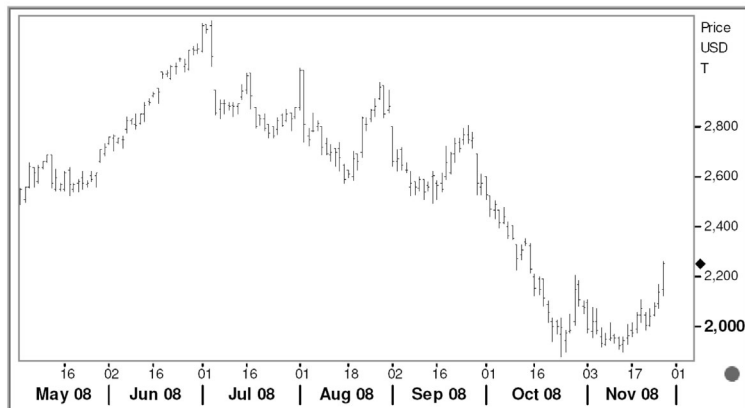
fore forecasting that the global consumption growth rate in 2008-09 will fall to below 2%, from an average of about 4% over the past several years.

The ICCO is looking for a 2008-09 surplus of 88,000 tonnes, after a 71,000-tonne deficit in 2007-08. This forecast is obviously not expecting the worst-case-scenario for the Ivory Coast described above. At this point we would have to agree that this is rightly so. We begin most seasons with some fairly wild predictions, and the crop always seems to muddle through.

The potential disaster of the Ivory Coast eking out only 1 million tonnes, however, could be very bullish and could leave the market with a deficit of several hundred thousand tonnes, particularly if the weak demand picture we've seen over the past few months snaps back.

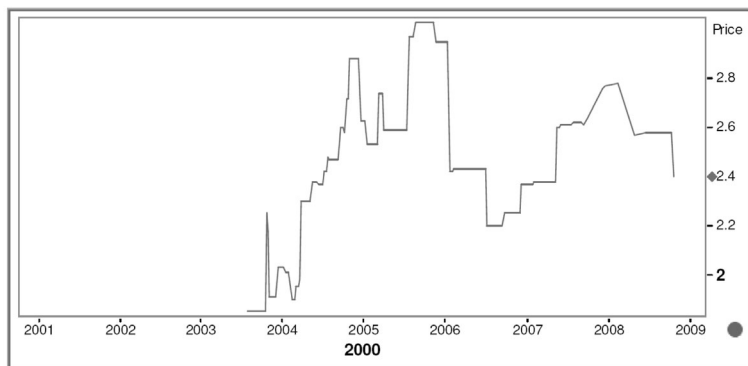
Regarding our September 16 recommendation of "...maintaining manageable long positions," well, we hope you heeded the "manageable" part, because even after the recent rally, you'd still be \$250 per tonne offside. Nonetheless, having come this far, we continue to advise maintaining long positions and to now use the \$1,900-per-tonne level as a stop. *[November 26, 2008]*

Chart 4 – March cocoa



Courtesy Reuters

Chart 5 – Asian butter ratios



Courtesy Reuters

**CORN**

**Sinking demand**

VeraSun Energy Corporation is (was) the largest publicly traded ethanol producer in the US. It filed for bankruptcy protection on October 31. Only 3 of its 16 plants will remain in operation – for now at least, unless there is a meaningful restructuring through new investment. The company used about 500 million bushels of corn annually to produce roughly 12% of the nation’s ethanol.

Although petroleum prices have fallen dramatically, which should dampen the urgency of completing the development of the ethanol infrastructure in the US, it was not a drop in ethanol demand that brought the company down. A failed hedging program, which made VeraSun effectively long corn at substantially higher prices, allegedly left the company unable to meet margin calls, and it was forced to liquidate.

There is also talk that other producers are going to be forced to shut down, which would result in a total loss of 1 billion bushels of corn demand, or a whopping 25% of total corn-for-ethanol usage. Express-lane demand destruction.

It is fairly safe to say that ethanol production will probably not fall quite that much in the near term. One analyst estimates that 2008-09 corn-for-ethanol usage will be revised downwards by 250 million bushels.

Profitability for ethanol producers has improved because of lower corn and natural gas costs, so at least some of the lost VeraSun processing will shift to producers that remain solvent. But it is a marginal factor, because while corn may have fallen much more than ethanol prices over the past few months, Chart 6 shows that corn is still very expensive in historical terms.

For the first time in quite a while, the focus of traders’ attention will be the corn-for-ethanol usage figure in the monthly USDA supply/demand situation report to be released on December 10. It will be critical to see how the USDA deals with the relatively sudden development.

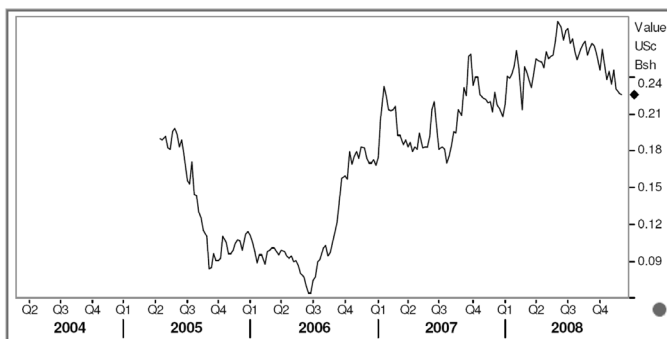
But the bearish case is much deeper. US feed demand for 2008-09 is estimated at 5.3 billion bushels, down from close to 6 billion bushels in 2007-08. These are not mere projections, but based on smaller animal populations, both in the US and abroad.

Furthermore, exports are abysmal. Export commitments as of last week stand at 18.3 million tonnes, compared with 34.4 million tonnes at this time last year. The USDA is forecasting exports for the marketing year to fall to 48.26 million tonnes, a 22% drop from 2007-08, which is far more optimistic than the 47% drop indicated by current commitments.

The risk of cancellations still exists, because most of the contracted sales were made when spot prices were still above \$5 per bushel. The USDA has been trimming its forecast, but will have to become more aggressive if sales do not pick up.

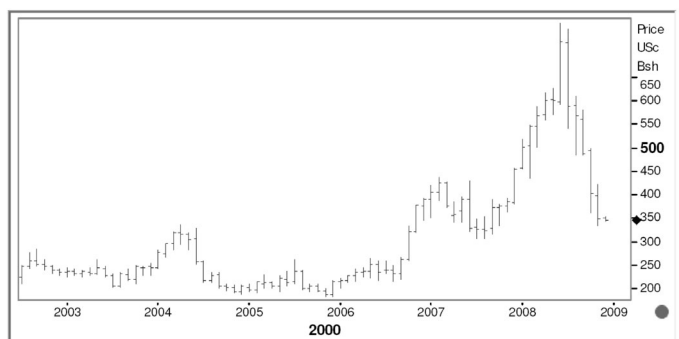
The global balance sheet – as it stood in November – has not yet shifted from bull to bear market status. The USDA estimate for global ending stocks was 110.1 million tonnes, or 13.8% of consumption, still down from 16.3% at the end of 2007-08. A further drop in US ethanol and export demand should be incorporated in the December estimate. While it is difficult to quantify, it is reasonable to expect the estimate for global demand to be revised down by between 5 and 10 million tonnes, which would close the gap significantly on the current

Chart 6 – Weekly corn/ethanol ratio



Courtesy Reuters

Chart 7 – Weekly nearest contract corn



Courtesy Reuters

projection for a further global production/consumption deficit of 16.3 million tonnes.

Corn prices have already undergone a major adjustment to account for the excesses of the commodity bull market. Those excesses resulted in the forced liquidation by speculative funds, and as amply illustrated above, by commercial interests. Still, we are trading substantially above pre-bull market levels (Chart 7), particularly when considering that new-crop December 2009 can be sold at a 60¢-per-bushel premium to spot December. This

carrying charge is not outrageous in terms of the historical normal range, but it is at the high end. With the drop in natural gas prices resulting in cheaper fertilizer costs, farmers can plant profitable corn crops at these new-crop prices.

The markets are in recovery mode, and just as everything went up together and then down together, we can expect countertrend recoveries to move in harmony as well, regardless of whether it is warranted. Look to establish short positions in new-crop months on rallies. *[December 1, 2008]*

## **WHEAT**

# Have we solved the world's wheat problem?

After a massive plunge from over \$13 per bushel (never mind the \$23-per-bushel Minneapolis squeeze), wheat prices have been consolidating above the \$5-per-bushel level, at least in the sense that they have not made new lows in over five weeks (Chart 8). Does it mean anything?

Our first point is not specific to wheat. Most analysts are bearish on commodities, almost indiscriminately, and certainly when it comes to industrial commodities. As headlines document layoffs and bankruptcies, it is only natural for people to be pessimistic about the prospects for consumption of goods and services. Most commodity markets have not yet erased all the bull market gains, and there is a strong belief that tumbling demand will ensure that every last vestige of the monumental bull will be wiped out.

The most recent period similar to the environment we now find ourselves in was the mid-1970s recession, in which commodity prices experienced a huge bull market only to see a massive setback when inflation caused a severe recession to set in (Chart 9). The key observation, however, is that while commodities drifted aimlessly through the end of the 1970s, they never dropped back to their old levels. Of course that was an extraordinary inflationary period, and the present-day concern is deflation, so perhaps the periods are not quite as comparable.

But there are other factors at play that make it worthwhile to investigate whether conditions have changed enough to allow prices to drift all the way back to the original ranges. While a good deal of the modern-day bull market was generated by hedge funds and the like, there was also a necessary adjustment for explosive demand from rapidly modernizing developing economies that would – hopefully – spur an increase in output.

So how is wheat faring in this regard? Well, for years, wheat was “under-produced.” By the time the 2008-09 winter wheat crops were planted in 2007, wheat prices were

already trading consistently in the \$5-per-bushel range – well above the historical norm, and that was enough to send virtually every major wheat producer on a planting spree. Global output in 2008-09 jumped to a record-by-far 680 million tonnes, from 2007-08 output of 610 million tonnes. Therefore, with the combination of producers' response to demand and the ongoing liquidation of speculative positions, prices are justifiably falling

According to the November USDA supply/demand situation report, the estimate for 2008-09 global ending stocks has jumped to 22% of consumption, compared with 19.3% at the end of 2007-08. It's an improvement, but it is still below the level of the late 1990s and early 2000s, when global ending stocks were averaging about 35% of usage.

It is quite unpopular to cite bullish factors in commodity market circles these days, but a review of major producers shows that we are not completely out of trouble in the wheat market. For example, European crops were plentiful, but in many cases, the additional output did not really participate in solving the world's food problems. Western European crops were of high quality, but a significant percentage of Eastern European output was only feed quality. The bounty was arguably more bearish for the corn market than it was for the food-quality wheat contracts that we trade, because of the additional supply of carbohydrate feed available in an already over-supplied market.

As we mentioned in our last article on wheat (see *Focus on Futures*, September 16), Australia is a large factor, because it is a significant supplier of food-quality wheat to the Asian market. In the early going, the crop suffered from drought. Now that the crop has muddled through and is being harvested, there is excessive precipitation, which cuts protein content and lowers the affected wheat to feed grade. The USDA estimated that Australia would have 13.5 million

tonnes available for export, but a recent local estimate puts that number at 12 to 13 million tonnes before subtracting about 1 million tonnes of the compromised wheat.

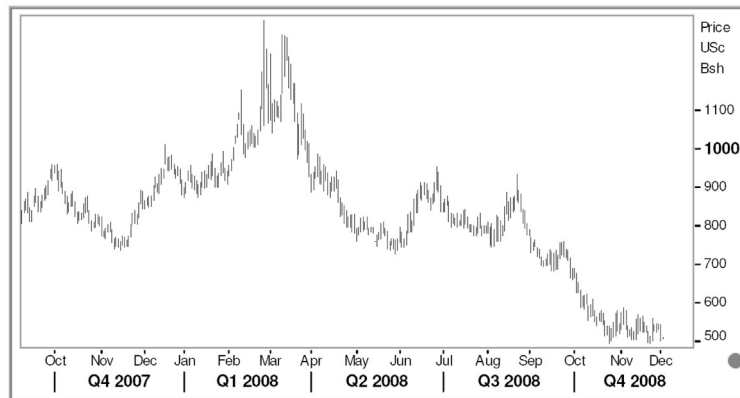
US exports for 2008-09 are expected to fall by 21% from the previous season, to 27 million tonnes. Export commitments to date are running 27% behind last year. Considering the reported difficulty for importers in obtaining credit and compared with the far worse corn numbers (see *Focus on Futures*, December 1) this is not an irreversible situation. It is early in the marketing year, and the world needs to eat.

We believe that the bulk of the downside damage is done

and that the outlook is uncertain. Producing nations would have to repeat this year's performance to avoid slipping back into deficit territory, unless, of course, the decline in consumption accelerates. Early estimates show that US winter wheat acreage will be down over 2 million acres, or about 5%, from last year. Ukrainian winter wheat area is estimated to be down 9%.

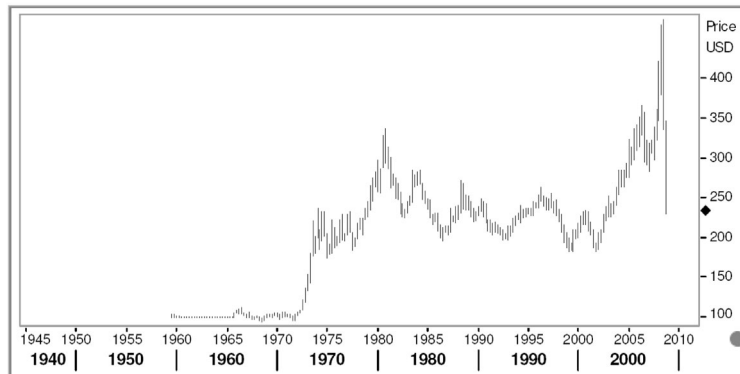
We have no specific recommendation at this time, because the mindset of the market is bearish across the board, and you have to be very selective in choosing longs. By the same token, we are not hiding our long-term bullish bias. Stay tuned. *[December 2, 2008]*

Chart 8 – Nearest contract wheat



Courtesy Reuters

Chart 9 – Quarterly CRB Index



Courtesy Reuters

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