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FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 17, No. 3 December 4, 2014

If China won't buy cotton, who will?

Cotton prices have fallen to levels last seen in 2009 (Chart 1). Northern Hemisphere 2014-15 crops are now being harvested. Global output of 119 million bales is expected to be about the same as the previous season. Output is estimated to grow by 5 million bales to 113.7 million bales, but it will not make a dent in burdensome ending stocks, which are estimated at 94.2% of consumption. And for now, that is all that counts.

China has imposed import restrictions that will serve three purposes. Aside from whittling down the stockpile that has accumulated since it embarked on a buying spree in 2011, it will help meet its World Trade Organization quota. In addition, the policy will help protect its farmers.

To illustrate the potential impact on the market, consider: In its October crop report, the USDA revised the estimate for 2014-15 Chinese imports down by 1 million bales, to 7 million bales. That's down from 14 million bales this past marketing year and from 20 million bales in 2012-13. So, as with almost all internationally-traded commodities, when China stops buying, prices will fall.

Interestingly, a closer examination of Chinese purchases from the US thus far this marketing year, which began on August 1, reveals that the situation is not as dire as the forecasts indicate. Chinese commitments this year stand at 980,000 bales, which is actually above commitments of 825,000 bales at this time last year.

In keeping with analysts' forecasts, the USDA estimates that exports to all foreign buyers for all of 2014-15 will reach only 10 million bales, 500,000 bales less than last year. As of the most recent weekly export report, however, total commitments stand at 5.8 million bales, compared with only 4.6 million bales at this time last year. With prices at multi-year lows, though, this is not a shocking development as buyers look to meet their needs with low-priced cotton, and is therefore not necessarily a signal that actual demand is stronger than anticipated. All things being equal, it is reasonable to assume that the healthy pace of US exports will fade as the season wears on.

Another bearish factor to watch is the fact that synthetics could enter a fresh phase of competitiveness as petrole-

um prices have nosedived more than 25% over the past few months.

Despite the reasonable pace of export growth, the prospect for continued growth is limited. Clearly this paints a bearish picture from the demand side.

Looking down the road at the supply side, however, there are several factors that will keep prices from falling too far. First, the incentive to plant is not enticing. Although grain prices have fallen substantially, cotton has fallen more. Hedging new-crop contracts for soybeans, corn, and wheat have all presented better profit opportunities (Chart 2) over the past several months.

Moreover, production costs for cotton have remained stubbornly high. The costs can vary widely, depending on yields, and can be anywhere between 65¢ and 75¢ per pound, which does not leave much – if any – room for profits.

To illustrate, Informa Economics came out with an early estimate for plantings a few weeks ago, which puts US cotton area for the 2015-16 crop, to be planted this coming spring, at 9.5 million acres, down from 11.1 million acres in 2014-15. If demand stays steady, that would put US ending stocks back to very vulnerable levels.

Trend followers who are short this market should remain so, but maintain buy stops above 66¢ per pound, basis December. Otherwise, stay tuned.

[By Sholom Sanik, November 7, 2014]

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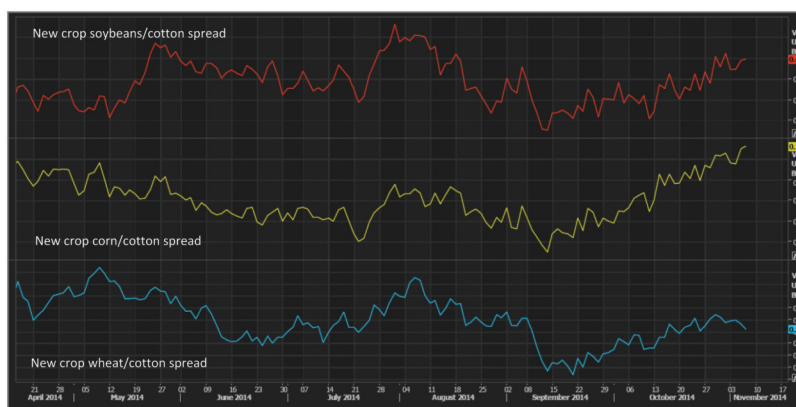
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Chart 1 – Weekly nearest contract cotton



Courtesy Bloomberg LP

Chart 2 – New crop spreads



Courtesy Bloomberg LP

WHEAT

An early US winter and drought in Australia halt the slide in wheat prices

Wheat prices have sprung to a three-month high. There are two recent developments that are driving the rally.

Australia is a significant wheat exporter and the largest exporter to Asia. The 2014-15 crop is now being harvested, and dry weather is expected to lower yields materially. In its November crop report the USDA already lowered its output estimate by 1 million tonnes, to 25 million tonnes. But analysts have slashed their estimates further, to as low as 22 million tonnes. In 2013-14 Australian production reached 27 million tonnes. This could have an immediate impact as traditional customers such as Indonesia, Japan, South Korea, Malaysia, Vietnam, and Sudan look elsewhere to meet their needs.

An early-winter blast in the US could hamper the emergence of recently-planted winter wheat, particularly the soft red winter variety grown in the Midwest. According to the most recent weekly crop progress report, 83% of the crop

had emerged, above the five-year average of 79% for this point in the season. We're guessing that the survey could be based on sample regions and does not necessarily represent some key areas where more current reports seem to indicate a slower rate of emergence. The report estimated that 60% of the crop was in the good-to-excellent category, compared with 65% last year, but in all probability that too is subject to revision.

In almost every winter-wheat planting season that we can remember there are crop scares. Adequate precipitation in the growing season, when the plants emerge from dormancy, is far more crucial to plant development, though, so it is very premature to worry about crop failures at this juncture.

In any case, even taking into consideration the more pressing problem of smaller Australian output, the market is well supplied. Global ending stocks for 2014-15 are estimated at 193 million tonnes, or 27% of consumption, up

from 26.4% in 2013-14. The November USDA crop report did not fully account for a worst case scenario of a 22-million-tonne Australian crop. That would pull the ending stock figure down to 26.8% of usage, still higher than the previous two marketing years.

The EU harvested a record crop of 155 million tonnes, but as we discussed in our previous article on wheat (see *Focus on Futures*, September 23), weather problems reduced a significant portion of the crop to feed quality.

This could eventually open the door for more demand for US wheat, although you wouldn't know it from the current pace of exports. The wheat marketing year is well under way – it starts on June 1. Year-to-date commitments stand at 15.4 million tonnes, down from 20.9 million tonnes at this time last year. That's down 26.3%, compared with the USDA forecast for a drop of only 21.3%.

With ample global inventories, the odds are that this weather rally will fail, sooner-or-later. But chances are

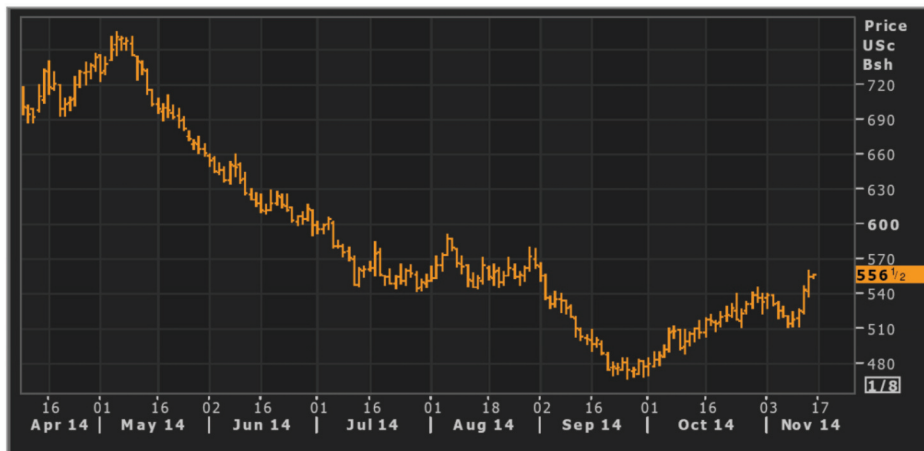
equally good that US exports of high-quality wheat will improve from their current dismal state.

Our September 23 recommendation to buy the higher-protein content old-crop Kansas City Board of Trade (KCBT) wheat contract and sell CBOT wheat, hoping that foreign demand for bread quality wheat would pick up, was stopped out. The concept still has merit, but has been delayed. Chart 4 shows that while this spread has collapsed (top graph), the same spread, using new crop months, representative of the winter-wheat crop now being planted for the 2015-16 season, has actually improved over the past few weeks (bottom graph).

We therefore recommend reentry of this trade, but by using next year's new-crop contract months. Buy December 2015 KCBT wheat and sell December 2015 CBOT wheat, currently trading at a spread of about 45¢ per bushel. Place initial stops at 30¢ per bushel.

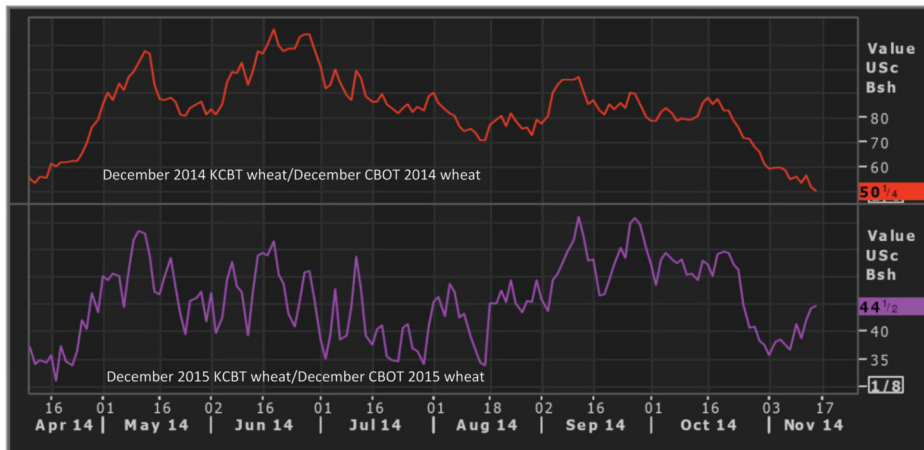
[By Sholom Sanik, November 14, 2014]

Chart 3 – December CBOT wheat



Courtesy Bloomberg LP

Chart 4 – December KCBT wheat/December CBOT wheat



Courtesy Bloomberg LP

CORN**Lots and lots of corn. The bull market did its job**

The 2014-15 US corn harvest crop is just about complete. After planting and growing seasons that featured weather conditions nearly as ideal as a farmer could ever hope for, the national-average bushel-per-acreage (bpa) yield will reach record-by-far levels. The November USDA yield estimate was actually a bit of a disappointment. The average of analysts' guesstimates was 175.23 bpa, which would have been up from the October estimate of 174.2 bpa, but the figure came in at 173.4 bpa.

Even after a net-downward revision to the domestic consumption side, the lower yields resulted in an 80-million-bushel downward revision to ending stocks. But at 14.7% of consumption, the carryover will still be at its highest level since it reached 17.5% in 2005-06.

Although ethanol usage in the US continues to grow, the growth rate has plateaued. The USDA revised its forecast up 25 million bushels from its October estimate, to 5.150 billion bushels, which is up a bit from 5.134 billion bushels in 2013-14. US demand has dropped off from its peak in 2012-13, when 42% of total usage was attributed to ethanol. This marketing year, that number will drop to 37%. Ethanol has become a permanent component of US corn demand, but farmers have successfully adjusted output levels to accommodate the market.

The global market is well supplied. Ending stocks are expected to grow to 19.7% of consumption. That compares with 18.1% last year and is the highest level since 2002-03.

The EU harvested a record wheat crop this year, but a higher-than-normal amount will not be food grade because of inclement weather. The additional feed-grade wheat will compete – at least to some degree – with corn in the carbohydrate feed market.

To illustrate: The USDA estimates that US exports will

be only 8.7% smaller than last year. However, the most recent weekly export report shows corn commitments 15% behind last year at this time. It is not very likely that the dismal US corn export outlook is going to improve much as the marketing year wears on.

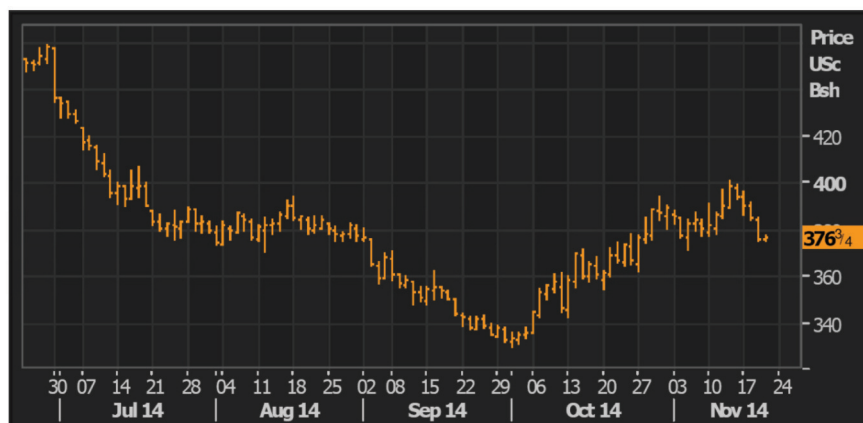
The rally that began in early October is waning (Chart 5). The only bullish development during this period that could have affected near-term supplies – and a moderate one at that – was the expectation that US yield estimates would be trimmed, as indeed they were. Commodity funds established long positions as the market approached the \$3-per-bushel mark and have now accumulated a large net-long position that is not supported by the supply/demand fundamentals, as described above (Chart 6).

Looking ahead, Informa Economics released a preliminary acreage estimate for the 2015-16 crop year, which will be planted this coming Spring, at 88.3 million acres, which would be down from this season's 90.5 million acres. Lower acreage intentions are not a surprise. Planted acreage in 2013-14 and 2012-13 was 95.4 million acres and 97.3 million acres, respectively. Farmers were able to lock in prices that were several dollars per bushel higher than they are now. With new-crop prices where they are now and silos bursting at their seams, the incentive to plant corn has been materially diminished. Burdensome global inventories will have to be worked off before lower production prospects become a bullish factor.

We see the market range-bound for the foreseeable future. For traders with somewhat shorter-term time horizons, the market should slip back to recent lows and should therefore be traded from the short side, with buy stops at \$4.10 per bushel, basis March, close only.

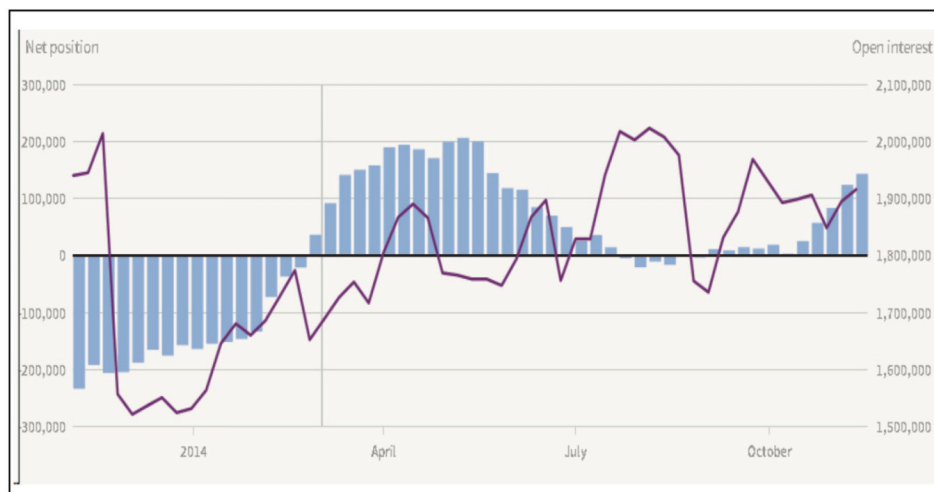
[By Sholom Sanik, November 20, 2014]

Chart 5 – March corn



Courtesy Bloomberg LP

Chart 6 – CBOT corn open interest (line), Speculator net-long position (bar)



SUGAR

The bear is about to hibernate

Parched sugar cane regions in Brazil are finally receiving much needed precipitation, which will be beneficial for the 2015-16 crop. This year's crushing season is drawing to a close, though, and the effects of drought during the growing season are in the books. Total output for the 2014-15 marketing year is currently estimated to be about 3% below last year, but the shortfall could mount.

The rains are a mixed blessing – while vital for next year's crop, it is bringing an early halt to the crush. Consider some statistics from the tail end of the crush: At this time last year, only 31 of the center south's 320 mills had shut down for the season. This year 82 have ceased operations. Output for the first two weeks of November is down 39% from the same period last year.

In addition, the sugar/ethanol crush ratio typically favors sugar near the end of the season. This year, in the first half of November, close to 60% of the cane crush went to ethanol, the highest ethanol ratio of the season, and compared with only 53% during the same period last year. As we mentioned above, look for 2014-15 sugar output estimates to slip even further.

Thailand is the world's second-largest exporter behind Brazil. Its ample stocks provided part of the backdrop for weak sugar prices over the past year. Drought was a formidable problem in Thailand as well, and production is expected to fall by 10%, or about one million tonnes, from the previous season. There will be no problem meeting export commitments, but the poor 2014-15 output will eat into its burdensome inventories.

The Indian mill saga drags on. Millers are still not paid up to cane farmers, and the crushing season has once again

been delayed as mill owner's haggle with the government over subsidies. True, the industry muddled through this past season, even with the month-long delay late last year, and produced a very respectable 24.5 million tonnes of sugar. However, some stark vulnerability looms. Sugar content decreases as the cane lies around waiting to be crushed.

As we've pointed out – *ad nauseam* – in previous *Focus on Futures* issues, the economics of sugar production are weak: Low world prices (Chart 7) pitted against rising costs. Sooner or later, it will manifest itself in the lack of incentive to produce.

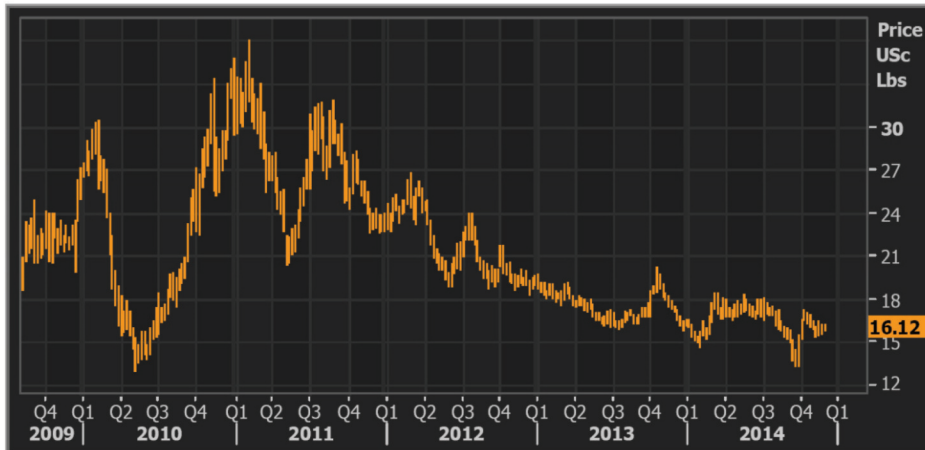
Demand is not running away, but continues to grow at about 1.5% per annum. The era of bountiful sugar supplies is drawing to a close. After years of global surpluses, just about all the major sugar analysts are forecasting production/consumption deficits for the 2014-15 marketing year and, looking forward, for the coming 2015-16 season. For the current year, the estimates range between a 1-million-tonne surplus and a 3-million-tonne deficit. For next year, analysts are estimating a deficit of between 1 and 3 million tonnes.

Commodity funds have been covering shorts over the past few weeks, but have barely made a dent in the formidable net-short position (Chart 8). With supply-side developments becoming increasingly bullish, as detailed above, we continue to believe that it is only a matter of time before this market moves out of the basement.

Until now we have recommended clinging to long-term call options. At this time we see the downside risk fading and feel confident in upgrading that recommendation. We now advise buying May sugar. Place initial stops at 15.75, close only.

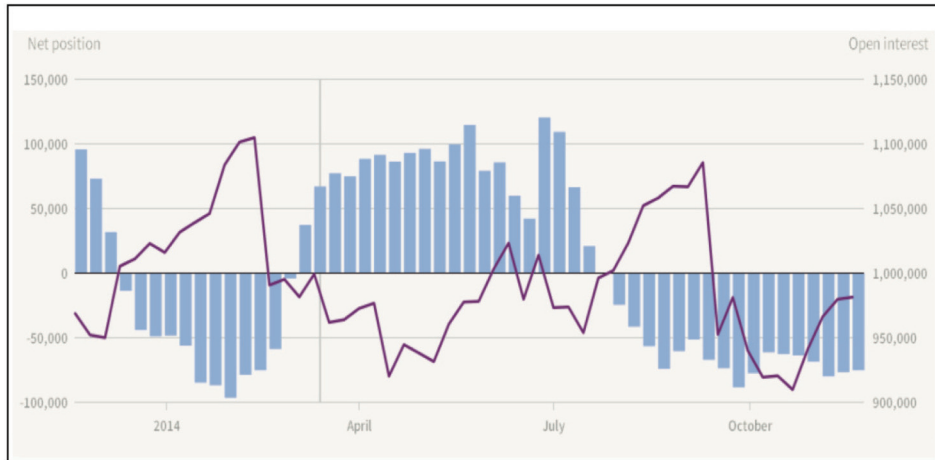
[By Sholom Sanik, November 27, 2014]

Chart 7 – Weekly nearest contract ICE sugar



Courtesy Bloomberg LP

Chart 8 – Commodity fund net-short position (bar chart)



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