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Copper: wandering aimlessly, but Chinese imports can keep the market afloat

Copper prices continue to bounce back and forth within the confines of a relatively narrow range, seeking direction (Chart 1). Production growth has been strong, but demand has been as well – mainly in China, where it counts.

In September, Chinese imports spiked to a 19-month high. The recently-released data for October show that the buying cooled down a bit, with imports falling 11.2% from the previous month. Nevertheless, the average of the past few months remains near the level of the frenzied buying days of late 2011. Chart 2 (which does not include the drop in October) shows the robust import activity that began in May.

Bonded warehouse stocks have increased a bit over the past two months, but, at an estimated 350,000 tonnes, they are still down sharply from their peak, which reportedly reached 1 million tonnes earlier this year.

Official data are not necessarily the most reliable in the world. However, if the general trend of increasing imports and declining stocks is at least somewhat accurate, we can make the assumption that copper, as well as the other base metals, whose prices have been strong, are being utilized for bona fide industrial purposes.

Production growth in Chile has been somewhat disappointing in recent years, but this year has been different. Despite declining ore grades and labor issues, output has exceeded expectations. Through the end of September, Chilean output has grown 6.3% over the same period in 2012. That's a stronger pace than the 5% growth forecast earlier this year.

One contributing factor to Chile's production boom has been the return to health of Collahuasi, the world's third-largest mine. In 2012 the mine was plagued by all the traditional Chilean mining industry problems, such as ore grades, labor strife, and inclement weather, in addition to accidents, which saw output fall by 37%.

China is now the world's second-largest copper miner. Year-to-date output is up 15.2%. While its production is still dwarfed by Chile's, it is a contributing factor to growing

world supplies. At the moment, however, the fact that China is still importing copper attests to the reality that demand in China remains strong.

According to the most recent International Copper Study Group (ICSG) report, which covers the period between January and July, the global balance sheet posted a 150,000-tonne deficit in July, bringing the year-to-date balance to a 93,000-tonne deficit. As recently as the end of April, the market was showing a 266,000-tonne surplus.

Global exchange-warehouse statistics also confirm that the market is tightening. Chart 3 shows the combined inventories at LME, COMEX, and Shanghai warehouses have declined by 240,000 tonnes since June.

The lackluster directionless trade we've been witnessing reflects the relative balance between the supply and demand sides. We are cautiously bullish, because Chinese buying can overwhelm any influx of supply – should its importing habits be maintained.

We recommend using the recent swing to the low end of the multi-month range to establish long positions. Buy March copper and place initial stops at 315, close only.

[By Sholom Sanik, November 8, 2013]

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Chart 1 – March copper



Courtesy Bloomberg LP

Chart 2 – Chinese copper imports

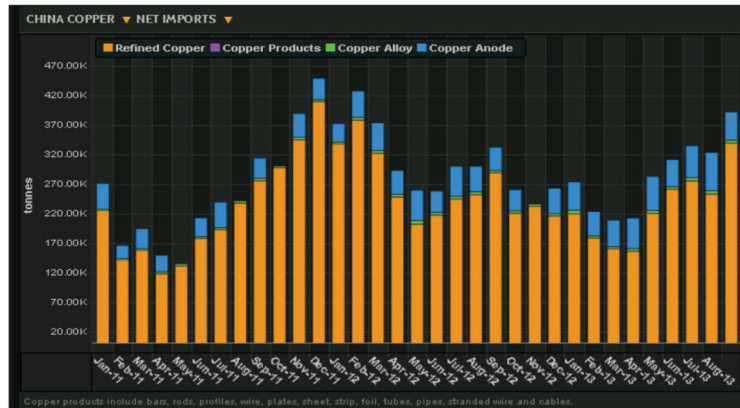


Chart 3 – Global exchange copper warehouse stocks



SOYBEANS

Robust demand to be met by equally robust crops

The long awaited, post-shutdown USDA crop report was released on November 8. And while the report did not contain any big surprises, the market behaved as though it did. Soybeans and soybean meal both rallied sharply back

to the highs of their recent ranges (Chart 4).

It was well known that the weather improved in the final stages of the 2013-14 US growing season, providing a boost to the crop that was planted late and had its share

of weather problems earlier in the season. In the last crop report before the shutdown on September 12, the USDA estimated the soybean yield at 41.2 bushels per acre. The average guesstimate was for an increase to 42.407 bpa, but the estimate came in at 43 bpa.

The number of harvested acres was expected to fall, but they were even lower than expected, which mitigated the bearish tone set by improved bpa yields to some degree. The average guesstimate was 75.93 million acres, but the figure came in at 75.7 million acres, down from the 76.4-million-acre September estimate.

The end result was still a better-than-anticipated crop estimate of 3.258 billion bushels (88.66 million tonnes), up from the September estimate of 3.149 billion bushels (85.71 million tonnes) and above the average of analysts' estimates of 3.222 billion bushels (87.69 million tonnes).

Demand estimates for both the domestic crush and exports, however, were higher than expected as well, which left the estimate for ending stocks of 170 million bushels, very near expectations of 172 million bushels. As a percentage of consumption, ending stocks rose to 5.2%, compared with the September estimate of 4.7%, which still leaves us with the task of explaining the initial bullish reaction, as well as the follow-through strength over the next few sessions.

On the global side there were virtually no changes to production estimates. Because of slightly higher demand estimates, ending stocks dropped to 26% of usage, down from the September estimate of 26.6%. That will still be the highest carryout since 2010-11 and represents a smart recovery from the previous two seasons. In 2011-12 and

2012-13 ending stocks were 21.4% and 23.9% of consumption, respectively.

In South America the 2013-14 crop is now being planted and will be harvested in the spring. On November 8, the Brazilian equivalent of the USDA said its crop could be as high as 90.2 million tonnes, based on planted area. That compares with the USDA estimate of 88 million tonnes, which will be yet another record, up from 82 million tonnes in 2012-13.

Argentinean output is forecast at 53.5 million tonnes, up from 49.3 million tonnes last year, but not quite a record. Production in 2009-10 reached 54.5 million tonnes.

The demand side has been strong. The crop report revised its estimate for 2013-14 US exports sharply upwards, by 2.17 million tonnes, to 39.46 million tonnes, up from 35.91 million tonnes in 2012-13 – which would be a 10% increase in US sales. But US export commitments are running substantially ahead of last year at this time – by 28%. This pace is obviously not sustainable, but does provide some insight into the market's bullish reaction to what seemed to be – at best – a neutral report.

We will have to contend with the inevitable volatility that will be generated by weather forecasts over the long planting and growing seasons in South America. Nevertheless, we maintain that the bumper crops in the US and South America will leave the market with ample supplies to meet growing consumption.

We stand by our October 4 short-sale recommendation. Keep stops at \$1,350 basis January, close only.

[By Sholom Sanik, November 12, 2013]

Chart 4 – January soybeans



Courtesy Bloomberg LP

JAPAN YEN/NIKKEI

**Japanese yen and Nikkei 225:
two sides of the same coin**

The Japanese yen and benchmark Nikkei 225 equity index both broke out of significant consolidations last week (Charts 5 and 6). The moves are highly related; in fact, the negative correlation between Japanese equities and the yen has been incredibly consistent over time (Chart 7).

From a quantitative perspective, the Nikkei 225 has demonstrated a reliable beta of -3 with respect to the currency, whereby a 1% decline in the value of the yen results in a 3% gain the Nikkei 225. While it is difficult to objectively demonstrate causality, logically a weak yen leads to greater export competitiveness, and in an export-oriented economy like Japan's, this is vitally important to corporate earnings. Therefore, yen weakness should be seen as the driver behind the strong Japanese equity market.

There are a number of factors driving the yen lower, with the most immediate catalyst likely being Janet Yellen's Federal Reserve confirmation hearings in the United States. She is generally viewed as one of the more dovish members of the FOMC, and as Chairwoman of the Federal Reserve, she is expected to maintain monetary stimulus for the foreseeable future. Her eventual placement as the head of the world's most powerful central bank has supported a new wave of risk-on sentiment, and in that environment the Japanese yen traditionally weakens.

At the local level, Prime Minister Shinzo Abe has been working hard to end the persistent deflation that has plagued Japan for decades. He has overseen unprecedented government bond buying as one of the three pillars of so called "Abe-nomics." Bank of Japan Governor Haruhiko Kuroda is now buying more than ¥7 trillion worth of government bonds each month, aiming to reach 2% inflation within two years. The market expects that the BOJ will increase the pace of asset purchases next year to compensate for the rise in the sales tax in 2014 to 8% from 5%. The BOJ meets this week, and on Thursday, Nov. 21 may provide new insight into central bank policy.

Comments last week from Japan's Finance Minister Taro Aso also helped weigh down the yen, as he reiterated the importance of retaining the option of intervening in currency markets should the yen appreciate. Japan is one of the few developed nations to make a habit out of intervening in the currency markets, so Mr. Aso's comments provide some comfort to yen bears.

Short positions in the Japanese yen and/or long positions in the Nikkei 225 are warranted in light of the strong breakouts, with stops at 14,500 for the Nikkei and 101.50 for the yen (basis December futures) should the breakouts fail.

[By Jaime Macrae, November 18, 2013]

Chart 5 – Front-month yen futures



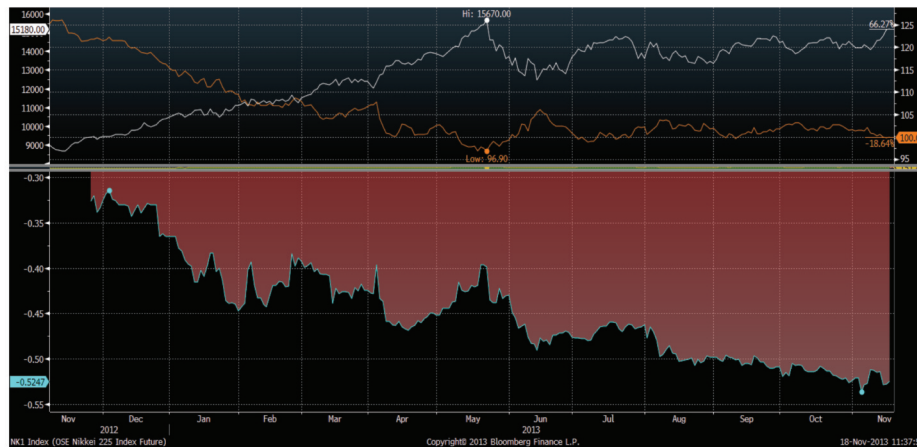
Courtesy Bloomberg LP

Chart 6 – Front-month Nikkei 225 futures



Courtesy Bloomberg LP

Chart 7 – Nikkei 225/yen correlation chart



Courtesy Bloomberg LP

CRUDE OIL

WTI and Brent crude: distinct energy markets

For all of the bearish headlines espousing the sharp drop in the price of crude oil, you'd be forgiven for missing the move if you were anywhere outside of North America. While West Texas Intermediate crude is on pace for its third consecutive monthly decline, which would be the longest losing stretch in nearly five years, its trans-Atlantic cousin, Brent crude, is flirting with its highs (Chart 8).

The declining relevance of WTI as a benchmark for global crude trade is being reflected in the weightings of the largest commodity price indices, the most energy intensive of which is the Goldman Sachs Commodity Index. The S&P GSCI is weighted based on global trade, and has the largest pool of assets tracking its performance. For 2014, S&P has

announced that it will increase the weighting of Brent crude to 23.14%, while reducing the weighting of WTI to 23.73%. To provide some context, back in 2008 WTI represented over 40% of the index, and Brent a mere 14.7%.

As discussed in previous *Focus on Futures*, the divergence in prices is driven primarily by a confluence of ever-expanding domestic production in the United States, a mismatch of pipeline and storage infrastructure relative to the sources of new production leading to bottlenecks, and refining capacity running near its limit. Together, these forces have conspired to drive an ever-widening gap between WTI and Brent crude prices.

Traders are therefore left with two distinct crude mar-

kets, driven by their own respective fundamentals. Brent crude, the clear benchmark for global crude oil prices, reflects geopolitical factors such as Iranian nuclear negotiations, difficulties with Libyan production, and myriad other “surprises” that maintain a risk premium in global crude prices. WTI, meanwhile, is relatively immune to such influences, and is driven primarily by domestic supplies, particularly at the Cushing hub – the delivery point for WTI futures contracts.

Despite the complex relationships between these benchmark prices, the driver behind the spread itself is deceptively simple. Chart 9 shows the WTI-Brent spread overlaid against the crude stocks held at Cushing, Oklahoma. The correlation is stark, and easy to understand, since expanding supplies in Cushing are symptomatic of the larger problem of moving crude oil from where production is growing (such as in the Bakken shale, Chart 10) to where it is used, namely the US Gulf coast. In that light, what will move the prices closer together is exactly what moves crude itself, pipelines.

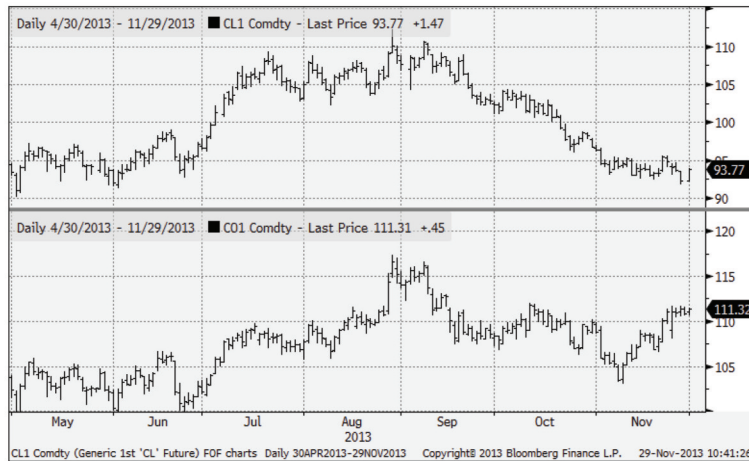
The brief tightening of the spread over this past summer, and the corresponding drop in supplies held in Cushing, was a direct result of increased rail transportation of crude oil, as well as an expansion of the Seaway Pipeline capacity. The Seaway Pipeline runs from Houston, Texas to Cushing, Oklahoma, traditionally carrying crude from the Gulf into the oil trading hub of Cushing.

The direction was reversed back in 2012 to counter the growing glut of supplies landlocked mid-continent, and the capacity was expanded from 150,000 barrels per day (bpd) to 400,000 bpd in 2013. By mid 2014 the capacity is expected to increase to 850,000 bpd, helping to alleviate the bottleneck, and depress the spread between WTI and Brent crude.

While in the medium term, pressure from infrastructure expansion should lead to a tightening of the spread, continued growth of US production will keep a lid on WTI prices (Chart 11). Short traders should stay focused on US crude, while those trading with an eye on geopolitical factors should favor Brent’s more global footprint.

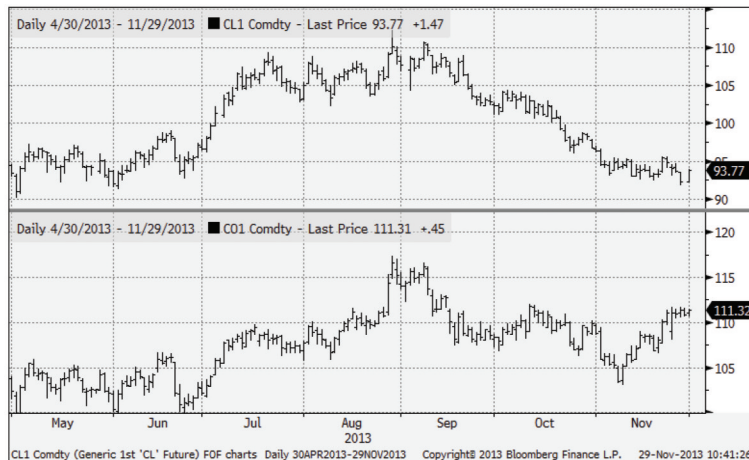
[By Jaime Macrae, November 29, 2013]

Chart 8 – WTI (top panel) and Brent (bottom panel)



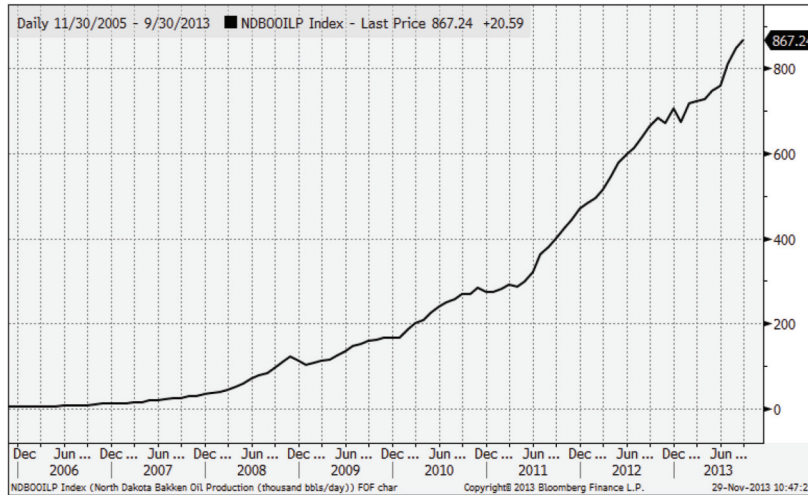
Courtesy Bloomberg LP

Chart 9 – WTI-Brent spread vs. total oil stock in Cushing, OK



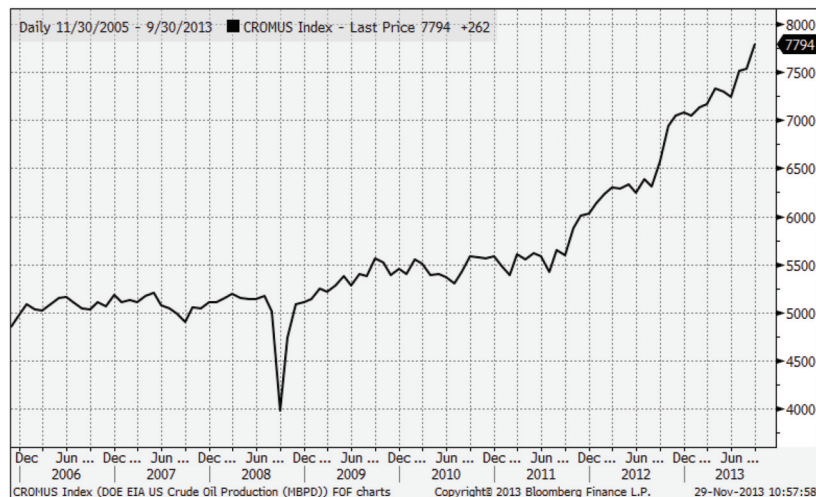
Courtesy Bloomberg LP

Chart 10 – North Dakota Bakken oil production (thousand bpd)



Courtesy Bloomberg LP

Chart 11 – Total US crude oil production



Courtesy Bloomberg LP

SUGAR

Sugar bears *think* they have the upper hand

After teasing bulls with a spike to 20¢ per pound, sugar prices have eroded all the way back to their July lows.

The October 18 fire at the Santos Port terminal in Brazil turned out to be a one-day event. Total monthly sugar shipments for Brazil have been down by more than 10% as a result of the damage to the facility, but the market was never very worried about the world supply situation. Some

sugar shipments from the damaged warehouses will restart in January. More capacity will be restored by May. A combination of other ports picking up some of the slack and a well-supplied world market has allowed sugar prices to fall back to the lows.

Atypical dryness for this time of year is a mixed blessing for the Brazilian cane industry. On the one hand, it

allows mills to continue crushing the current crop, but on the other it deprives the developing new crop of much-needed moisture. In any case, despite the harvest of a 10%-larger cane crop, estimates for sugar output for the center-south region – where 90% of Brazilian cane is grown – have not changed much from the 34.5-million-tonne estimates we've seen over the past few months.

In mid-October, a large percentage of sugar mills in India balked at the government-controlled minimum price that they must pay to farmers for cane, claiming that it is too high and that they cannot turn a profit while world sugar prices are so low. Crushing normally begins in early November, but the millers refused to start the crushing season. The protest lasted for a few weeks, but eventually the millers caved in, and the crushing season got under way.

There was talk that the delay would tighten world supplies, but again – like the Brazilian port situation – even before the dispute was settled, nobody seemed to be very concerned. The director general of the Indian Sugar Mills Association assured the market that despite the delays, Indian mills are still in perfect shape to meet export forecasts of between 3 and 4 million tonnes for the 2013-14 marketing year. Bears did not even blink as world prices continued to slide.

The standoff between the Indian millers and the government, while resolved without incident, underscores what

we've been talking about – *ad nauseam* – over the past year. Production costs in the major sugar-producing nations, such as India and Brazil, have increased dramatically over the past few years, but prices have been falling. Ultimately, we will see mill closings, as we have in Brazil and the near miss in India. The market did not react – true. But how long can it last?

Production costs are unlikely to drop. Energy prices teetered a bit recently, but remain near historic highs. Labor costs in developing nations are rising. If world sugar prices do not stabilize and then rise, falling production and the inevitable deficits that are sure to follow will replace the burdensome surpluses we have at the present.

It will be a slow grinding process, but we believe it has begun. The International Sugar Organization (ISO) estimates that global sugar production fell 1.2% in the 2013-14 crop year, while consumption rose by 2.2%. There was still a production/consumption surplus of 4.7 million tonnes, but it will fade. The ISO forecasts that the trend of lower output and increased consumption will continue in 2014-15, with production falling by about 1.5% and demand increasing by 2.2%, which would result in a deficit of about 1.5 million tonnes.

We maintain our recommendation to hold positions in long-term sugar calls. At about 55 tics, October 2014 18¢ calls are a steal. Load up.

[By Sholom Sanik, December 5, 2013]

Chart 12 – March sugar



Courtesy Bloomberg LP

CORN**Is a single bumper US crop enough?**

The November USDA crop report presented a mixed picture for the now completely harvested 2013-14 US crop. We missed the October crop report because of the government shutdown, but it was well known that improved weather during the latter part of the growing season had bumped yields up substantially from early-season estimates. The average of analysts' guesstimates was for a jump to 158.93 bushels per acre (bpa), up from the September estimate of 155.3 bpa, but the actual figure came in at 160.4 bpa.

Although yields were better than anticipated, there was no appreciable increase in the size of the crop, because the abandonment rate was much higher than expected. The September estimate for harvested acres was 89.1 million acres. Analysts were looking for a drop to 88.1 million acres, but the actual figure was 87.2 million acres, which is below even the disastrous 2012-13 season.

Demand estimates were revised meaningfully upwards, and as a result, ending stocks were well below expectations. Notably, the export estimate was increased by a hefty 175 million bushels. Analysts were expecting ending stocks to rise significantly from the 1.855-billion-bushel September estimate, to 2.029 billion bushels, but the increase was only moderate, with stocks rising to 1.887 billion bushels. Despite the disappointment, that still leaves the estimated carryout at 14.6% of usage – a new paradigm for US inventory levels. The average of the previous three marketing years was 8%.

Prices have fallen substantially to account for the far more comfortable stock level. In our last discussion of the corn market (see *Focus on Futures*, October 22), we recommended looking for rallies to establish a short position, but the market has been drifting lower, and there really has not been much of an opportunity (Chart 13).

There have been several bearish developments, but none have pushed prices beyond their consolidation range

of between \$3.20 and \$3.30 per bushel. The Chinese have refused some US shipments, which were found to contain GMO corn. And the story about the reduction in the government's ethanol mandate has been making headlines. We explained the latter at length in our October 22 article. In short, the ethanol factor is no longer bullish, but it isn't bearish either. The monstrous growth rate of usage has ended, but as long as the government maintains a minimum 10% blend requirement, the US will continue to use about 5 billion bushels of corn for ethanol.

There are two bullish factors to consider. First, the export pace has been brisk. US sales have averaged about 1 million tonnes per week, and commitments stand at 26 million tonnes for the marketing year that began on September 1. The huge jump in the estimate for 2013-14 sales that we mentioned above brings projected shipments to 35.5 million tonnes, up from 21 million tonnes last year.

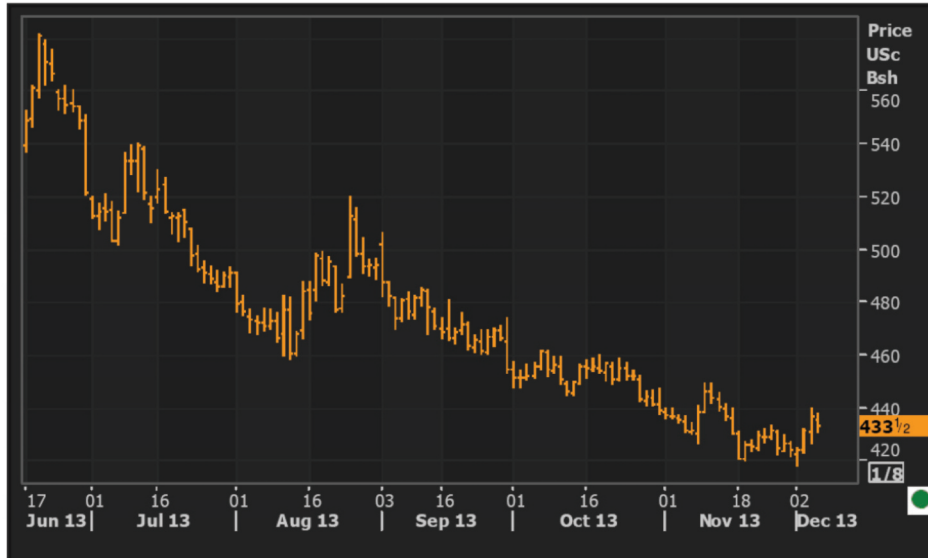
That brings us to the second point. In stark contrast to soybeans, there has been no growth in South American production. Argentinean output is estimated at 26 million tonnes, down slightly from 26.5 million tonnes last year. Brazilian production is expected to fall to 70 million tonnes, down from 81 million tonnes in 2012-13. The US remains the supplier of last resort in the corn market.

Chart 14 explains why. Soybean prices have been rising *vis-à-vis* corn prices, which makes soybean planting far more profitable. And that's not just for South America. To illustrate just how potent a factor this could become, consider the mid-November planted-acreage estimate by Informa Economics for the 2014-15 crop to be planted in the spring. It puts soybean acreage at 83.8 million acres, up from 76.5 million acres this year. Corn acres, however, are estimated at 91.5 million acres, down from 95.3 million acres planted in 2013-14.

We therefore rescind our short sale recommendation. Remain sidelined.

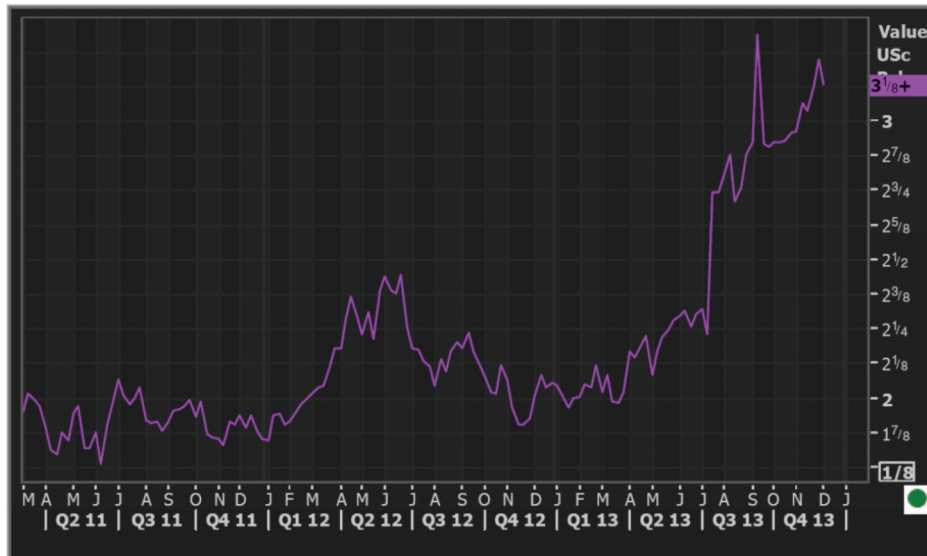
[By Sholom Sanik, December 6, 2013]

Chart 13 – March corn



Courtesy Bloomberg LP

Chart 14 – Weekly soybean/corn ratio



Courtesy Bloomberg LP

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