FRIEDBERG'S

FOCUS ON FUTURES

Friedberg Mercantile Group Ltd. Volume 16, No. 8 February 11, 2014

Traders shrug off smaller US wheat acreage

Unlike most exportable commodities, US wheat production has been in decline since the early 1980s. Even as world trade grew, US participation shrank, as other producing nations picked up the slack.

The winter wheat crop – planted in the fall and harvested the following spring – comprises about 75% of US output. The USDA reports its first comprehensive look at winter acreage in January, and this year the report provided traders with quite a surprise. Winter wheat area had increased for three consecutive seasons, and the street was expecting the trend to continue. The January 10 estimate came in at 41.892 million acres, down from 43.09 million acres planted in 2013-14, and more importantly, substantially below the average analysts' guesstimate of 43.501 million acres.

The very bullish US report did not matter much, though, because traders focused on international developments. For the current marketing year, global production is estimated to have jumped by 8.7% over 2012-13 output, to a record 713 million tonnes. Demand will grow as well, but only by 3.5%. Ending stocks will increase to 26.4% of usage, compared with 25.9% last season.

In itself, the carryover is not that overwhelming in historical terms – the average of the previous five years was 28.38%. But the market is focusing on huge production increases in countries that will have exportable surpluses. For example, Canadian farmers harvested a record-by-far 37.50 million tonnes, up from 27.21 in 2012-13. And FSU output was 105.02 million tonnes, up from only 77.46 million tonnes the previous year. So the market's reaction – completely ignoring the drop in US acreage for the upcoming 2014-15 season, with a selloff to new lows for the move – was quite understandable (Chart 1).

The market has been moving sideways since the release of the report, and we believe that in the short term, prices are likely to consolidate. Although the global ending-stock figure was higher than last month, as noted above, it was not an earth shattering revision. The market will soon begin to pay close attention to Northern Hemisphere weather as the winter crops emerge from dormancy down the road. It's been a brutally cold winter in the US, and some key regions may have experienced some damage.

While the US role in international trade has diminished over the years, this year's export trade has been brisk, and could prove to be a factor that bears have not taken into account. At 24.9 million tonnes, US export commitments are 25.7% ahead of last year at this time. Even after revising the target for 2013-14 up by 680,000 tonnes in the January 10 crop report, the USDA forecast for annual foreign sales is only 11.7% above last year. Still, US prices are not highly competitive with international prices, so there is a risk that the pace will fall off.

Over the past couple of years, wheat was very cheap relative to other coarse grains, and was therefore very competitive as a feed. So part of the equation will be corn prices. Chart 2 shows, that wheat prices have recovered *vis-à-vis* corn prices, further adding to wheat's waning competitiveness on the world market.

Overall, we presented a bearish view. The market should be traded from the short side. However, commodity funds are heavily short this market, as depicted in Chart 3, which makes the market vulnerable to short covering on any bullish news. The Bullish Consensus is hovering at 52-week lows. We therefore advise patience, and look to establish short positions on the inevitable rally.

[By Sholom Sanik, January 23, 2014]

Inside

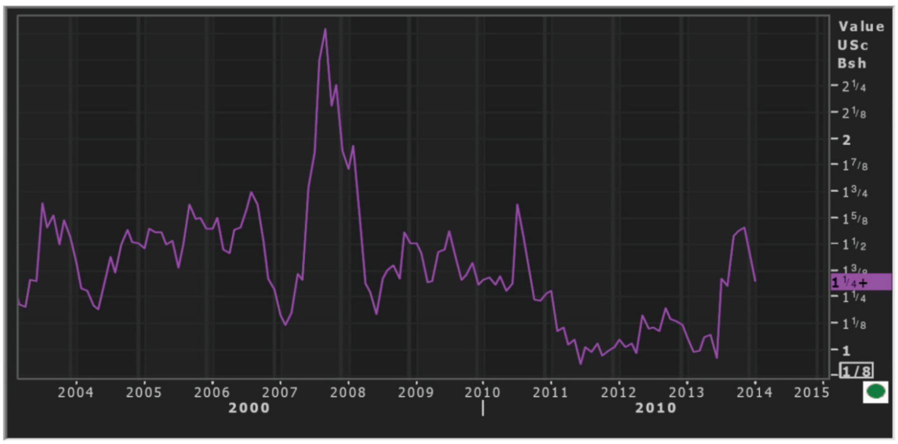
Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

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.

Chart 1 – March wheat

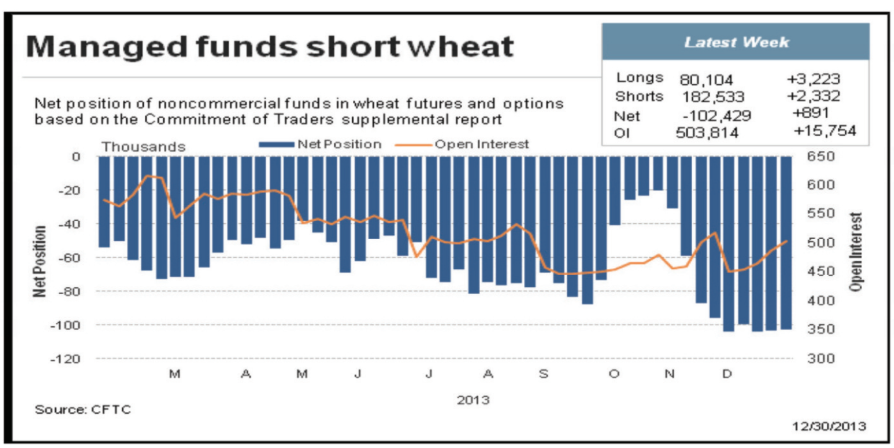
Courtesy Bloomberg LP

Chart 2 – Nearest contract wheat/corn ratio



Courtesy Bloomberg LP

Chart 3 – Commodity funds net short position



Courtesy Reuters

SOYBEANS

Booming US exports are not telling the whole story

Over the years, bull markets in soybeans have been made or been broken by US exports. Looking at 2013-14 export statistics in isolation would surely cast the impression that supplies are being depleted by importing nations. It's only January, but USDA export data show that commitments stand at 42.5 million tonnes, compared with 33.3 million tonnes at this time last year. If all of it is shipped (more on that later), annual sales would surpass the record of 41 million tonnes set in 2010-11. Furthermore, the commitment tally is 2 million tonnes above the USDA estimate for 40.7 million tonnes for the whole marketing year, which extends to August 31.

In addition, US exporters have already shipped 30 million tonnes, or 71% of commitments. That's a much higher ratio than in recent years. The average shipment-to-annual-sales ratio at this juncture of the season over the past five years was only 57%. The market is trading at multi-month lows, however, and the picture painted by the charts is not that of a budding bull market (Chart 4).

There are mitigating factors, though. The possibility of cancellations always looms large as we head into the South American harvest, and with huge crops expected, it could be a particularly ominous threat this season.

One reason US sales have been so brisk is that Argentinean farmers are rumored to be holding back as much as 10 million tonnes of old-crop beans in anticipation of a devaluation of the peso. The government is not happy about the situation because foreign soybean sales represent a significant source of tax revenue, which means that – sooner or later – the standoff will be resolved. If the numbers are accurate, US sales would slow to a trickle once the wall of old-crop beans finds its way to the market.

That and the sheer magnitude of the size of the soon-available new crops could overwhelm the market. In its January 10 crop report, the USDA raised its estimate for Brazilian 2013-14 production by 1 million tonnes, to 89 million tonnes, up from 82 million tonnes in 2012-13. That estimate, however, is already stale. On January 28 the US attaché raised the estimate to 89.5 million tonnes, and that estimate is conservative when compared with some private Brazilian forecasts, which are as high as 91.5 million tonnes. The Argentinean estimate has remained fairly constant at 54.5 million tonnes.

There are reports that China has been canceling some bean commitments. Of greater and long-term concern, though, is the new policy that was announced on January 19. The government will end stockpiling soybeans and cotton this year. It will continue to support farmers through an alternative facility that would involve direct subsidies. But it could very well mean the end of the era of massive imports for soybeans and cotton.

The torrid pace of US exports is therefore not as meaningful as it may have been in the past. Global ending stocks were revised upwards in the January crop report, to 72.33 million tonnes, or 26.7% of consumption. That's not quite a record, but if the higher Brazilian forecasts are accurate and China starts cutting back imports, inventory levels will continue to be revised upwards.

Maintain short positions. Lower stops to $1,300 per bushel, basis March, close only.

[By Sholom Sanik, January 31, 2014]

Chart 4 – March soybeans

Courtesy Bloomberg LP

SUGAR

Could this rally be for real?

Another pre-expiry rally in sugar? Perhaps. Last July we documented how short covering has dominated the market in the weeks leading up to the expiry of the near contract (see *Focus on Futures*, July 5, 2013). It happened again last October, and it is happening again now, as we head into the expiration of the March contract on February 28 (Chart 5). The rally comes with some bullish news, though.

Falling prices have been attributed to expectations of a bumper 2013-14 Indian cane crop and near-record sugar output of 25 million tonnes. Domestic consumption is estimated at 23 million tonnes. Normally comfortable carryover stocks were almost depleted after two crop failures in the 2008-09 and 2009-10 marketing years, but have since been rebuilt to about 35% of usage. The turnaround has allowed India to shift from self-sufficient producer to exporter. The farm ministry had been saying that sugar exports could reach 4 million tonnes in 2013-14. Recent developments may have derailed that optimistic outlook.

First, the crushing season got off to a late start because of a pricing dispute between farmers and crushers. Analysts predicted that if the season got underway by December, there would be no problem catching up. That does not seem to be the case. Output from October 1 through January 31 is reportedly 17% below last year at this time. It is early, and the mills can still catch up, but if they do not, the anticipated surplus will be nothing but a mirage.

Then, to complicate matters, the government was considering providing cash-strapped mills with financial assistance, but has now waffled on the plan.

At the heart of the issue is the fact that cane farmers have not lowered prices they charge mills in line with falling world prices, when at the same time labor and energy costs have increased.

This problem is not unique to India and will continue to hamper global production growth. Any way you slice it, the crushing industry in the major producing nations is not profitable with world sugar at these price levels.

Production estimates for the center-south region in Brazil, which accounts for about 90% of output, is estimated to be some 34 million tonnes, about the same as last year. Over the past few years, it is estimated that roughly 15% of the 320 sugar mills in operation have closed their doors, and many of the smaller mills are near bankruptcy.

If sugar prices remain depressed, the impact in Brazil is more direct than in other countries. Roughly half the cane grown in Brazil is used to make ethanol. If ethanol production is more profitable, the ratio will swing in favor of ethanol. Based on the most recently available figures, in December the ratio rose to 56/44 in favor of ethanol, compared with 52/48 in November. A 1 percentage point swing in the ratio is equal to roughly 800,000 tonnes of sugar. The ratio has been as high as 60/40 in recent years, and with sugar prices as weak as they are, we could be headed there again.

At the moment, as long as exporting countries are working off the surpluses generated over the past couple of seasons, the global supply situation is not in any peril. But this will not last forever. We're guessing that the Indian government will help the mills muddle through.

The drama transpiring in India, however, is only a microcosm of a much larger problem that will find its way to all sugar producers if prices continue to trade at 10% or 20% below the cost of production.

This rally may fade, as have the others. India will smooth things over, and commodity funds will use the rally to establish new short positions. Eventually, though, the current situation could become a model for the old truism that bear markets beget bull markets when prices fall enough to quash incentive to produce.

So is this rally for real? Time will tell. In any case, we maintain our long-standing recommendation to buy and hold long-term call options.

[By Sholom Sanik, February 5, 2014]

Chart 5 – March sugar

Courtesy Bloomberg LP

COCOA

West Africa cocoa crops lose their early-season luster

Our ill-timed exit from the long side of the cocoa market (see *Focus on Futures*, December 31) was precipitated by the unexpectedly strong performance of West African crops. We left $200 per tonne on the table (Chart 6). There have been several developments since – mostly bullish

First, the gap between this season's West African output and last year's has narrowed. At the end of December, Ivorian arrivals were 245,000 tonnes, or 40%, ahead of last year's pace. According to the most recent arrival data, they are only 19% above last season at this time.

Similarly, in Ghana, arrivals are only 16% larger than last year, compared with 40% at the end of December. Cameroon is set to harvest only 190,000 tonnes, down sharply from last year's record output of close to 240,000 tonnes.

To complicate matters, the outlook for the Ivorian mid-crop harvest, which normally begins in April, is looking a bit shaky. Widespread hot and dry weather is threatening to delay the onset of the harvest until May. This would mean a shorter season and fewer beans.

Fourth-quarter grind data showed that demand has been strong and arguably has been growing at the fastest pace in modern history. The EU grind was up 6.2%, a bit higher than analysts' expectations. At 4.4%, the US figures were slightly below expectations. And in Asia, grindings grew by 10%.

After a steep climb, butter prices have now consolidated near their highs (Chart 7). Powder prices are slightly off their lows, but still leave the combined ratio at depressed levels. It would seem, however, from the strong performance of the grind in all key global regions that butter, as always, drives the market.

The International Cocoa Organization (ICCO) was scheduled to release a report on the global cocoa market on January 28. Parts of the report were leaked to the press – or something of that nature – on January 23. The "preliminary" report indicated that the ICCO was set to revise its estimate for the 2012-13 production/consumption balance to a deficit of 310,000 tonnes from 160,000 tonnes – a very significant revision. The market took off on that news, and that was the catalyst for the most recent leg of the bull run. The ICCO did not comment, but when the January 28 report was released, it contained a statement saying that the part of the report that surfaced underestimated existing world inventory and that it would not revise its 160,000-tonne deficit estimate until its next report at the end of February. The market did not blink and went on to trade up to two-and-a-half-year highs.

Just about every season, there are periods in which it seems that the problem with aging plantations in the Ivory Coast will finally come to fruition. It has not happened yet. Output has remained steady at between 1.3 and 1.5 million tonnes, but traders are betting that this could be the year.

News reports that arrivals over the next few months will plummet have supported the market. Perhaps we're watching the worst-case scenario unfold, particularly since demand is growing at a pace that we've never seen before. A very bullish picture, indeed.

Open interest is at record highs, surpassing even the levels we saw in 2011 when prices reached $3,800 per tonne (Chart 8). Commodity funds are heavily long the market (Chart 9), which leaves the market vulnerable to a setback on any bearish news.

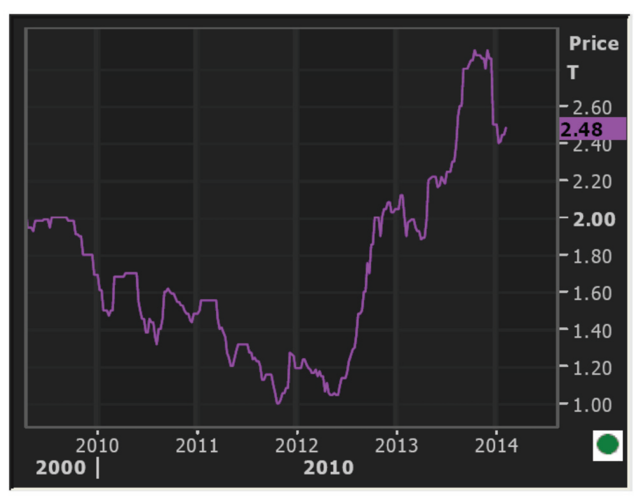
So, we're not about to recommend reentering the long side after such a powerful move. If we do see a pullback, it would be prudent to first judge whether a return to normal output levels in West Africa is the cause. Until then, remained sidelined.

[By Sholom Sanik, February 10, 2014]

Chart 6 – March cocoa

Courtesy Bloomberg LP

Chart 7 – Butter ratio

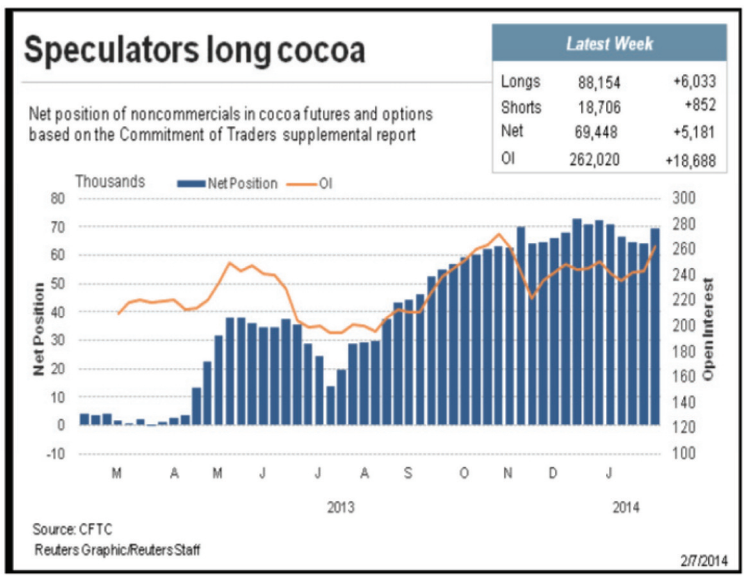


Courtesy Bloomberg LP

Chart 8 – Nearest contract (bar), open interest (line)

Courtesy Bloomberg LP

Chart 9 – Speculative long position



Courtesy Reuters

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