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## Sugar high Supplies likely to remain tight

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An unexpected drop in sugar production by key producers Brazil and the European Union caused prices to more than double last year, to 11.5¢ per pound from 5¢. While prices have pulled back from those peaks, the market could make a run at those highs and beyond.

Global output fell by about 6 million tons, or about 4.5%, from the 1999-00 season after having climbed through most of the last decade. That drop meant production fell short of consumption for the first time since the 1993-94 season. Global demand did increase by 1.5% last year, but that merely was in line with the average growth of the previous 5 seasons. Except for a spurt of buying by Russian importers, very tight – and thus bullish – supply-side developments dominated the market.

Prices peaked back in mid-October and have since been consolidating their gains. The market is now hovering near the mid-point of the 8.5¢ to 11.5¢-per-pound trading range. Where do we go from here?

As with almost all internationally traded commodities, the buying habits of Chinese consumers can make or break this market. Chinese consumption has grown steadily over the years, and production, though increasing, has not kept pace. China continues to have shortfalls, which have reduced inventories. Carryover stocks at the end of this season will equal 10% of consumption, compared with about 30% in the mid-1990s.

The introduction of just-in-time-inventory methods makes comparisons with past periods dicey, some observers say. But with an economy as large and dynamic as China's, such small stockpiles leave the market vulnerable to even the smallest surprise from either the demand or supply sides. Although estimates vary, most analysts agree China will have to import at least as much as it did last year to cover its shortfalls.

For sugar, however, the size of Brazil's crop and the availability of its exports are overriding issues. After producing a record crop of 21 million tons in the 1999-00 season and exporting 11 million tons, a combination of frost and drought battered the following year's output. Even with a

drop of more than 20% in the 2000-01 crop and a nearly 45% plunge in exports, Brazil still managed to export six million tons of sugar to maintain its status as the world's largest exporter.

The harvest of the current crop will begin in May. There have been no major weather problems, and the crop is likely to recover from last year's disaster. The extent of the rebound is the key. About 80% of the crop is grown in the center-south region in the state of São Paulo. While the area has avoided the drought and frost that plagued crops last year, precipitation levels have not been ideal.

Analysts currently estimate the crop should be somewhere between 5% and 10% larger than last year. Even if assuming the higher estimates are accurate, the crop will still be 15% smaller than the 1999-00 season's bumper crop and 7.5% smaller than the year before that.

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During last year's sugar crisis in Brazil, the government lowered the ethanol-gasoline ratio to preserve supplies for the export market. There is pressure on the government to ratchet the ratio back up to its previous level. Despite the conservation practiced last year, Brazilian consumption rose to 9.3 million tons.

Even if demand were to remain constant, a crop of about 17.5 million tons would leave 8 million tons for export, higher than last year's dismal 6 million tons, but far shy of the preceding year's 11 million tons. If domestic consumption were to grow, the expanded supplies will have accomplished little.

India represents an important piece of the puzzle as well. It is the only major producer that actually has any inventory of significance. India last year unloaded some of those stocks, which was the only bearish influence on the market. India's population growth is explosive. As with Brazil, its export program will depend on the recovery of its drought-reduced crop.

Until the Brazilian output picture becomes clear, the sugar market should retain its bullish poise. But even a best-case supply scenario will not replenish export needs fully. If there is any disappointment, we can expect the bull to charge right through the 11.5¢ level.

## **COCOA**

### **The bull market rages on**

The bull market in cocoa took a breather from mid-January through mid-February. Traders – speculators and knowledgeable commercials alike – were digesting the unexpected, powerful thrust that saw prices vault some 65% off multi-decade lows before the pause. This past week the trend resumed, and a new high was recorded, with the market briefly creeping over the \$1,200 per tonne, a level not seen since March 1999.

E.D.&F. Man's most recent report, published at the end of January, contained something of a surprise. It estimated the combined Ivorian main- and mid-crop at 1.16 million tonnes. This was above the figure the street was expecting based on the slowing pace of arrivals at the time the report. The price consolidation began immediately after the report was released as the market waited for more information on arrivals to see if Man's estimate was not perhaps too generous.

The most recent data out of the Ivory Coast – which is not necessarily terribly accurate, but all we have to work with – show that as of February 20, arrivals of main crop beans stood at 825,000 tonnes. With 10 weeks to go to the main-crop season and weekly arrivals having trickled down to below 10,000 tonnes and probably in decline from here on in, the most we could expect to see is something over 900,000 tonnes. This compares with Man's forecast for a 980,000 tonne main-crop. Most analysts agree that mid-crop output should reach no more than 150,000 tonnes, which would be about 50,000 tonnes below last year's mid-crop. This would put the total crop at about 1.05 million tonnes, or roughly 100,000 tonnes less than Man's estimate, and make the global production/consumption deficit look more like 300,000 tonnes rather than the 200,000 tonnes the market has been using as a worst-case scenario. Consequently, stocks as a percentage of consumption would be a lot closer to 35% rather than the bear-marketish 40%-plus it has been stuck at for so many

years. We believe that this explains the resumption of the rally this past week (Chart 1).

Skeptics argue that there have been years in which there were late spurts of arrivals and that there is reason to believe that this could happen again. Despite the problems with labor shortages, they say that with prices so high, every last bean from even the most remote region will find its way to the ports. This certainly makes sense. Market action, however, seems to be indicating skepticism about that theory, and until more beans turn up, the onus is on the bears to prove otherwise.

Most of the discussion about cocoa these days is focused on the size of the Ivory Coast's crop. Little attention has been paid to the issue of demand. In its most recent report, Man revised its forecast for 2000-01 global grindings down to a growth rate of 1% from 2% in its previous report. This is far shy of the 8.5% growth in consumption it estimates for the 1999-00 season.

With a buildup in inventories of products, analysts are doubtful that grindings will continue to grow at such a torrid pace. They point to December US imports of beans and products, which were down sharply from both the previous month and December 1999. Still, a drop from 8.5% growth to 1% is fairly large, and we reserve judgment on this issue until first quarter grinding statistics become available in early April.

After a move in prices of such magnitude, we expect to attract speculators, who in their zeal to make up for missing the initial leg of the rally, tend to cause prices to overshoot levels that represent the true fundamentals. However, the cocoa market has not displayed typical earmarks of a market inflated by speculators. First of all, CFTC commitment-of-trader data show that small speculators were net long 17,189 contracts in early January when the move began (Table 1). They have been liquidating their long positions all the way up and are now net long only 7,627 contracts.

Table 1

	As of Feb. 20	As of Jan. 2
Small speculators	Net long: 7,627	Net long: 17,819
Commodity funds	Net long: 474	Net short: 17,406
Commercial traders	Net short: 8,101	Net short: 413

Commodity funds have been buyers all the way up, but were operating from a position of weakness, because they were trapped short at the bottom of the market. At the start of the rally they were net short 17,406 contracts compared with their current position of net long 474 contracts. We could say that that source of buying power has now dried up because the funds have unwound their ill-fated short positions; however, not all the wounded are accounted for. Although cocoa open interest has fallen from a record 143,000 contracts at the end of October, it still stands at 117,000 contracts, which is still dramatically above the average of about 80,000 contracts. The open interest for the London cocoa market looks pretty much the same.

Tempering the still-bullish structure of the speculator's side of the open interest balance sheet is that anecdotal evidence of origin selling has emerged and is backed up by commitment data. Commercial traders have become net short 8,101 contracts compared with a flat position at the start of the move. Still, it is well known that the entire crop was hedged – probably overhedged – long ago. There are those who cannot meet their commitments and still have to buy large quantity of beans.

Small speculators have not been buyers – yet. Commodity funds are buying because they have to and probably will continue to do so until we see the open interest come down to more natural levels. When that's done, the funds are likely to get in the bull market spirit and push the market even further. When evidence of speculator interest becomes apparent from the open interest, we will begin to worry that prices are not being motivated by bona-fide bullish fundamentals. Until such time, we believe that prices will continue to trend upwards.

**CURRENT STRATEGY:** *Remain long May cocoa as per Flash Update of December 21. Raise stops to 1020, close only.*

Chart 1 – May Cocoa



Chart courtesy of Reuters

## SILVER

### No silver lining in this cloud

Aside from a spike to \$8 per ounce that was inspired by the “Berkshire Hathaway” purchases back in early 1999, silver prices moved back and forth between \$4.5 and \$6 per ounce for most of the 1990s (Chart 2). The market has now broken below the early 1999 lows of \$4.6 per ounce. Why are silver prices so weak?

The silver market has been in a production/consumption deficit since the early 1990s. Those deficits grew until they peaked at 203 million ounces in 1997. According to metal analyst CPM Group, the deficit will shrink to 97 million ounces this year, the smallest deficit since 1992. Naturally, the generally weak state of the economy cuts into the consumption of this or any industrial commodity. We feel that there are two other reasons for a backdrop of weakness that are exclusive to the silver market. Neither of them are going

to go away anytime soon.

First, a full 77% of all silver mined in the world is produced as a by-product of other base-metal mining. This means that production costs for the silver portion are just about negligible. Although silver producers have never been as active in the hedge market as their counterparts in the gold market, it certainly would seem to make a lot of economic sense for those who produce silver as a by-product to become so. The gap between market prices and their production costs is as wide as it is for any commodity we can think of. If the silver production community became worried that the bear market will continue, why wouldn't they hedge? This could add a whole new source of pressure on prices. In any case, we can be sure that rallies that look alluring to the bullish speculator's eye will be viewed as selling opportunities to miners

and capped in short order by hedge activity.

The second factor involves the ever-increasing popularity of digital photography, which does not use silver at all. According to CPM Group, the photography industry will consume 296 million ounces of silver this year, or 38% of total global consumption. In fact, it forecasts that the use of silver in photography will grow by 4% this year over last. We know, for example, that Kodak and Fuji each still purchased about 50 million ounces of silver last year. All the analysts that we spoke to seem to feel that while digital photography is definitely making inroads, it is still a drop in the bucket when compared with traditional technology. We can't argue with that. But how about the future?

We believe that demand-side dependence on silver halide technology and the photography industry's scramble to invest in the digital arena are not isolated situations. In a January conference call, in addition to blaming a miserable fourth-quarter showing on slack consumer confidence, Kodak Chief Executive Dan Carp said: "Kodak lost market share in digital cameras as competitors lowered prices." Polaroid's volume sales of digital cameras more than tripled in 2000 over 1999. We keep hearing that the annual rate of growth of digital cameras is only 2%. The anecdotal evidence that we see makes such a low growth figure suspect.

To hear that there are already cost-cutting battles brewing can only mean one thing: The age of the digital camera being a commercially viable, mass produced consumer good cannot be too far off. Much in the same way that cell phones were the domain of a high-disposable-income group only a decade ago and are now practically a staple (do you know anyone who doesn't have one?), it does not require a crystal ball to see that digital cameras will become increasingly affordable. As soon as the price of a digital camera gets close enough to the price of a traditional one, you can be sure that traditional cameras will slowly become very popular – in museums. With an ink-jet printer, which many people already have, the cost of home processing is already cheaper than sending film to the photo shop for developing.

Our theory is that the big users of silver in the photog-

raphy industry have begun to curtail purchases. That explains the weakness, at least in part. In any case, the photography portion of silver consumption cannot possibly be in a growth phase any longer. Weak economic growth and the inevitable slowdown in consumer spending that it brings, as well as the advent of digital photography will see to that. In addition, consider that the forecasts for a shrinking production/consumption deficit were probably made without too much consideration for loss of photography demand and the potential for hedge selling pressure. For all we know, the market may be very close to being in balance by the end of the year.

Open interest increased sharply during the current downleg in prices, indicating the presence of a fresh speculative short position, which – as markets go – will need to be covered as some point. Sentiment figures are very low as well. We've stepped aside for the moment, accepting handsome profits, but we believe that we are still in the throes of a long-term bear market. Be prepared to re-enter the short side on any substantial rally.

**STRATEGY:** *We covered our short position, but stay closely tuned for re-entry.*

Chart 2 – Monthly Spot Silver



Chart courtesy of Reuters

## WHEAT

# Relentless bear market or glorious buying opportunity?

We'll tell you right up front that we don't really know the answer to this question – yet. The statistics say one thing; the ticker tells a completely different story. You know who always wins. All we can do is inform you of the facts – as we see them.

The bullish world ending-stocks balance situation is no secret. Every analyst who covers the wheat market makes mention of it in virtually every discussion. Not to be left out, we will (ad nauseam) run it by you again. In its

February supply/demand situation report, the USDA lowered world ending stocks again to 108.9 million tonnes from the previous month's 109.9 million tonnes. As a percentage of consumption, stocks dropped a notch further to 18.25% from 18.42% last month and about 19% at the beginning of the marketing year.

Importers have become more confident in holding low inventories. An increase in mobility and free trade among many nations makes such complacency not wholly unjusti-

fied. Analysts keep telling us that stocks are the lowest in 30 years. The comparison between this era and that one may ring a bit hollow. We can safely relegate that comparison to ancient history. However, we don't have to go back that far to see that inventories are low even by current standards. Global stocks have now fallen below the lows of modern history as well. From the 1994-95 season through the 1996-97 season, stocks as percentage of consumption stood at about 20% (see Table 2).

**Table 2 – Global wheat stocks as a percentage of consumption**

1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
20	20	19.6	23.6	23	21.3	18.3

It took some time, but eventually the tightness caught up with the market. From the spring of 1995 until the market peaked about a year later, wheat doubled in price. So, at 18% of consumption, we are skating on thin ice. The argument for holding small inventories has strengthened, but at these prices the market has eliminated any and all premium for potential problems.

In January, the USDA released its first glance at winter wheat seedings. At 41.3 million acres, acreage was lower than expected and the lowest in 30 years. Yes, a brief rally ensued, but the high on the day of the report was the last we saw of that level and we've been plunging ever since. You just can't seem to find bullish news that's bullish enough in this market. Of course there are explanations. Kansas State University's *Ag Update* (February 5) says that despite the lower acreage, we can still achieve a winter wheat crop of about 1.6 billion bushels – slightly larger than last year – if yield-per-bushel is above trend.

A string of fairly decent export numbers gave the otherwise limp US export scene a glimmer of hope. Until this past reporting period, the average weekly commitment for February was 557,000 tonnes, which was slightly above the

level needed to achieve the USDA's annual target. In fact, commitments had taken over last year's pace for a couple of weeks, which was a bit of a surprise given the USDA's lowering of projected annual exports in this month's report. This past week's disappointing commitment of 290,000 tonnes, however, put a damper on things, and the pace has once again slipped back behind last year's.

On the international front, on February 23 the USDA attaché in India reported that the Indian crop is expected to drop about 10% from last year's record to yield only 68 million tonnes. Even with consumption at record levels – 71.5 million tonnes in 2000-01 – and an ever-expanding population, India will be able to weather this deficit because it will be able to draw on its inventories. It does, however, eliminate them as an exporting threat.

All in all, world production will decline, and consumption will continue to grow again in the 2001-02 marketing year. We believe that prices are restrained and will eventually move higher. Consider this: When the market peaked in January, commodity funds were net long 10,068 contracts. As of the most recent reporting period, they were net short 16,222 contracts! Very plainly, this means that the funds pushed the market down. Perhaps they are focusing heavily on the negative US outlook and ignoring the big picture. Or perhaps their trading habits have very little to do with the fundamental realities of the supply/demand balance.

Despite being beaten down as many times as we have been in trying to get long this market, we maintain that the tightness will eventually catch up with the non-believers, be they importers or trend-following commodity funds. An excellent analogy is a comparison with the cocoa market. The funds kept building a short position while ignoring the fact that the era of bumper crops in the Ivory Coast had finally peaked (see *Focus on Futures*, February 26). They paid dearly for ignoring the fundamentals.

**STRATEGY:** *Stay closely tuned.*

**Chart 3 – May Wheat**



Chart courtesy of Reuters

## HOTLINE UPDATE

**Flash Update – Monday, February 5, 2001:**

Good afternoon for Monday, February 5, 2:40 pm. This is a Flash Update. We have liquidated our long March copper position at 82.35.

**Flash Update – Thursday, February 8, 2001:**

Good morning for Thursday, February 8, 10:30 am. This is a Flash Update. We have purchased May sugar at 9.52, placing our initial stop at 8.75, close only.

**Flash Update – Friday, February 9, 2001:**

Good morning for Friday, February 9, 11:30 am. This is a Flash Update. We have rolled over our long March cocoa into May, placing our stop at 937.

**Friday, February 9, 2001:**

Good afternoon for Friday, February 9, 4:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short March silver, with our stop at 488; long May sugar, with our initial stop at 8.75; and long May cocoa, with our initial stop at 937. All stops are close only.

**Flash Update – Thursday, February 15, 2001:**

Good morning for Thursday, February 15, 11:50 am. This is a Flash Update. We have purchased June T-bonds at 102-22, placing our initial stop at 101-05, close only.

**Friday, February 16, 2001:**

Good afternoon for Friday, February 16, 4:15 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short March silver, with our stop revised to 472; long May sugar, with our stop at 8.75; long May cocoa, with our stop at 937; and

long June T-bonds, with our initial stop at 101-05. All stops are close only.

**Flash Update – Friday, February 23, 2001:**

Good morning for Friday, February 23, 11:15 am. This is a Flash Update. We have liquidated our long May sugar position at 8.92.

**Friday, February 23, 2001:**

Good afternoon for Friday, February 23, 4:20 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short March silver, with our stop revised to 462; long May cocoa, with our stop at 937; and long June T-bonds, with our stop at 101-05. All stops are close only.

**Flash Update – Tuesday, February 27, 2001:**

Good morning for Tuesday, February 27, 9:20 am. This is a Flash Update. We have covered our short March silver positions at 444.50.

**Flash Update – Friday, March 2, 2001:**

Good afternoon for Friday, March 2, 1:25 pm. This is a Flash Update. We have sold short April gold at 263.30, placing our initial stop at 271, close only.

**Friday, March 2, 2001:**

Good afternoon for Friday, March 2, 4:10 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long May cocoa, with our stop revised to 1020; long June T-bonds, with our stop revised to 102-05; and short April gold, with our initial stop at 268.50. All stops are close only.

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