FRIEDBERG'S

FOCUS ON FUTURES

Friedberg Commodity Management Inc.

Volume 5, No. 2 February 25, 2002

Burdensome copper warehouse stocks prove to be no deterrent for bulls

Copper prices have rallied as much as 20% off their November lows against a backdrop of data that seem to indicate that we are slowly climbing out of the economic slowdown of 2001. This notion was reinforced this past Wednesday with the Fed standing pat on interest rates and issuing some soothing comments in its communiqué. In addition, mining companies, panicking as they watched prices slipping off the charts during the gloomiest moments of the post-September-11 period, began announcing production cutbacks.

Have we seen the last of the bear market? To judge by inventory levels at the three principal global warehouses, one would have to conclude that this is hardly the case and that we are merely looking at a very handsome bear market rally. Stocks at the three exchange warehouses combined have grown by about 30% since the rally began in early November and stand at record highs (Table 1). The market's resilience is somewhat puzzling in the face of hefty, daily increases to warehouse stocks.

TABLE 1 – COPPER WAREHOUSE STOCKS

Exchange	Early November	Current
LME	730,000	853,600
COMEX	215,000	283,697
SHANGHAI	50,000	128,248

There is, however, ample rationale for the strength we've seen. In its most recent report, The International Copper Study Group (ICSG) estimates that the global supply/demand surplus stood at 434,000 tonnes at the end of the period between January and October 2001. The series of mine closures and cutbacks that was announced in November and December amounts to approximately 600,000 tonnes of production.

Skeptics argue that some of those announcements were worded carefully in a way that gives producers the chance to review the cutbacks if prices stop falling. Still, if only two thirds of the cutback announcements were honored, the surplus would be wiped out, and the market would be in balance.

After years of above-average growth, copper consumption fell in 2001. According to ICSG, usage in its study period slipped 3.8% from the same period in 2000, to 12.34 million tonnes.

Of course, it is difficult to say if the alleged recovery in the economy will be strong enough to stimulate growth in demand of industrial commodities. Phelps Dodge Corp., the world's second-largest copper producer said the other day that it expects consumption to increase by more than 2% in 2002. (True, it has a vested interest in talking up the market, but it was the most current and specific estimate available.) A 2% increase would be about 250,000 tonnes, and along with the cutbacks, would push the market into deficit.

In this issue

3 **Cotton** On missing the boat

4 **Gold** Bear market rally or bull market born?

5 **Gold** Central bank intervention

7 **Cocoa** Can the cocoa bull hold on?

8 **Hotline Update**

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

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

Focus on Futures available by e-mail

Focus on Futures is available by e-mail as a Portable Document Format (PDF) file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please let us know. Send us a message at focus@friedberg.com and give us your e-mail address as well as your full name and street address.

None of this – cutbacks or increased consumption – has happened yet, but the market is very optimistic that it will. March copper greeted the FOMC's decision with a powerful, 3.65¢-per-pound rally and a fresh, recovery closing high that dates back to last July.

Things seemed to make a lot of sense while inventories grew and were in line with falling prices. It should be obvious from current price action that warehouse stocks changes cannot always be a useful tool in determining readily available supply. This leads us to believe that the market is taking seriously both bullish issues – that production cuts will take place, and that demand is increasing.

We cannot blame the strength on short covering by commodity funds, because they have already covered and are now long the market. As of the most recent CFTC report, funds were net long 7,818 contracts. This compares with a net short position of 26,769 contracts at the beginning of the rally in November.

Charts 1 to 6 show what all the major base metal markets have done over the past decade. One observation is that despite substantial rallies, they are all still near their lows and, as such, have much upside potential if the bullish fundamentals described above were to develop.

The primary dynamic in these markets was the rapid growth of production that was not always commensurate with growth in consumption, particularly during periods of economic weakness such as the Asian crisis period and 2001. The announcements of cutbacks is – if nothing else – an indication that producers have come to realize that unchecked output is not good for their business.

So, yes, it is unlikely that we will return to the lows. We also believe that the market is about properly priced for now and will remain sidelined for the time being.

[January 31, 2002]

STRATEGY: *Remain sidelined.*

Chart 1 – LME 3-Month Copper

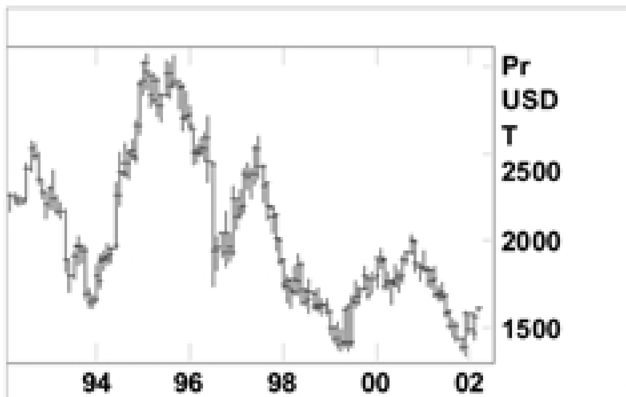


Chart 2 – LME 3-Month Zinc

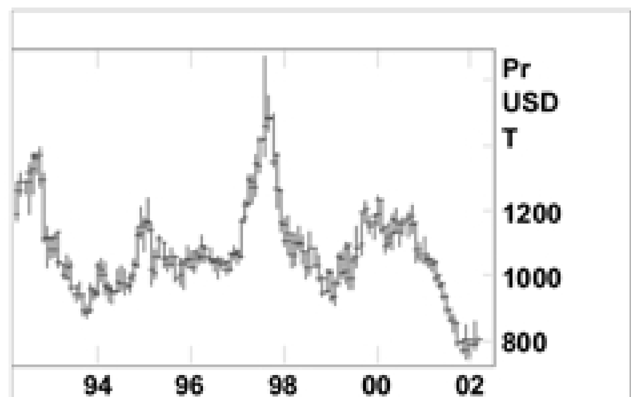


Chart 3 – LME 3-Month Nickel

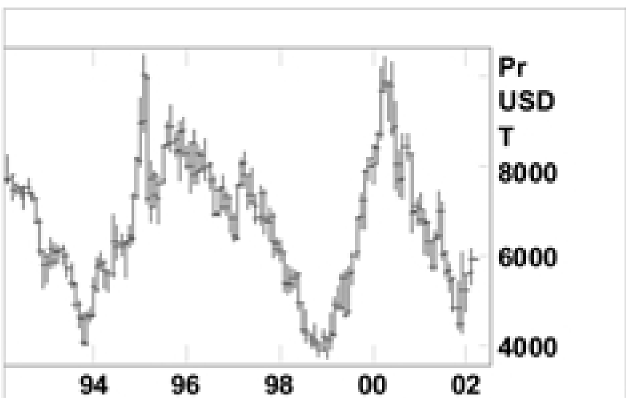


Chart 4 – LME 3-Month Aluminum

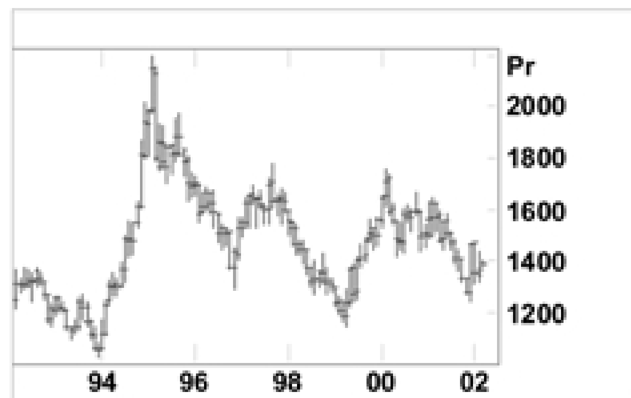


Chart 5 – LME 3-Month Lead

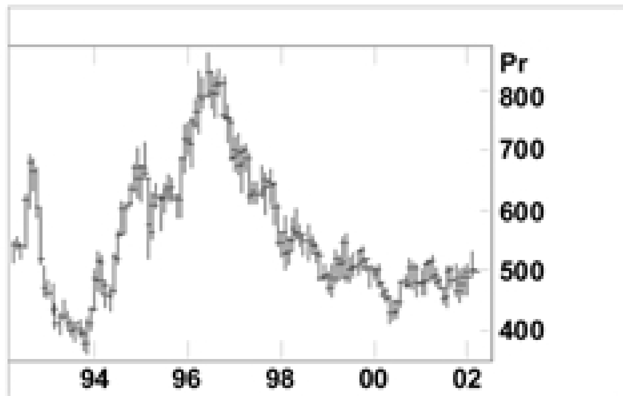
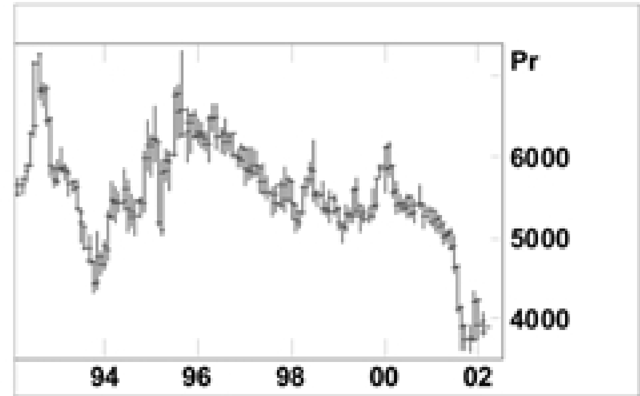


Chart 6 – LME 3-Month Tin



COTTON

On missing the boat

After taking a severe thrashing in 2001, cotton prices have bounced off multi-decade lows and stabilized. March cotton has maintained a 35¢-to-38¢-per-pound range since early November (Chart 7). Where is the market headed from here?

The US export picture continues to be the bright spot in this market. In its February supply/demand situation report, the USDA raised its estimate for 2001-02 exports once again, to 10 million bales from 9.8 million bales in the January report, to reflect the torrid pace of weekly sales. Commitments this season have consistently come in above analysts' forecasts, and this past week's export report was no exception. Net new sales were 208,000 bales, compared with analysts' forecasts of between 120,000 and 170,000 bales. Shipments for the period were 265,000 bales, yet another high for this marketing year. For the year so far, commitments stand at 9.4 million bales, compared with 4.9 million bales at this time last year. US exporters have shipped 4.8 million bales, compared with only 2.8 million bales at this time last year.

The domestic demand picture, however, remains bleak. The decline in mill consumption reflects a poor economic environment as well as structural changes in the industry. Textile and apparel imports are posing stiff competition for domestic goods, which explains both the drop in mill usage and increased exports.

Explosive growth in world production and stagnant consumption combined to create this bear market. The USDA raised its forecast for global production this month to 96.87 million bales. This compares with output of 88.53 million bales in 2000-01 and 87.35 million bales in 1999-00.

Consumption, on the other hand, has been constant at just below 92 million bales. Future demand will, of course, depend on economic recovery, which we are not going to attempt to predict. But we've already had a glimpse of what the output picture will look like for the major producing countries for the coming growing season.

On Friday, The National Cotton Council released its first estimate for US cotton plantings at 14.7 million acres. This compares with 15.8 million acres last year. The forecast came in higher than analysts' average estimates of 14.6 million acres. Still, even assuming yields will match last year's near-record performance of 698 pounds per acre, output will drop to about 18.5 million bales, compared with this season's 20.08 million bales.

The USDA attaché in India reports that cotton area will decline to 8.3 million hectares from 8.7 million hectares in 2001-02, which will result in a slightly lower crop than this year's 11.8 million bales.

The attaché in Pakistan predicts a slightly larger crop than this year's 7.8-million-bale crop, but the cotton growing regions have serious irrigation issues to deal with, and the crop will therefore be at the mercy of precipitation levels in the coming months.

The attaché in China is forecasting a decline of 14%, about 3.5 million bales, for that country's new crop.

India and Pakistan both have significant carryover stocks equal to about 35% of consumption, but both are still an important factor in world trade. India was a net importer of close to 2 million bales this season, while Pakistan imported a net 650,000 bales. China, which until last season was a net exporter, will – albeit reluctantly – be liberalizing its import quota system to meet its WTO entry requirements.

It's early and these projections are fairly crude, but based on the above calculations for the major producers, it does seem that global production will fall back in line with consumption in 2002-03, and at the very least put an end to the growth of inventories, which are estimated at 43.93 million bales, or a burdensome 48% of consumption. A pickup in consumption would actually create a drawdown.

When we last wrote about cotton in October, the March

contract was trading below 30¢ per pound. We were cautiously bullish but, unfortunately, not courageous enough to issue a buy recommendation. Now, with spot prices almost 10¢ per pound higher, it is no longer the same trade. There are bullish arguments to be made for the new crop months, but with October cotton trading at 43¢ per pound, the deep-discount bargains are gone. We retain a bullish bias, but remain sidelined. *[February 12, 2002]*

STRATEGY: *Stay tuned.*

Chart 7 – March Cotton

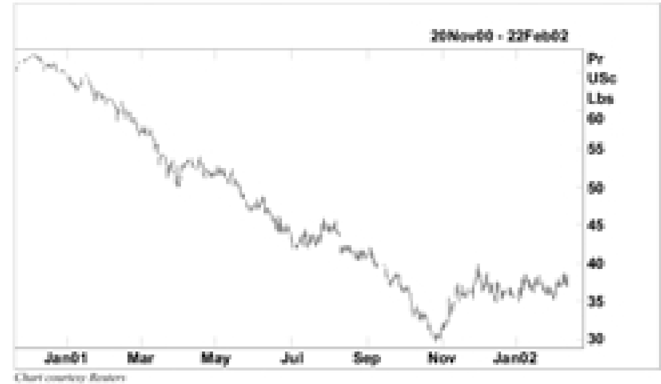


Chart courtesy Reuters

GOLD

Bear market rally or bull market born?

The rally in gold has paused to catch its breath. Or has it? Are we looking at a correction/consolidation? Or will this rally go the way of all other rallies in recent years and slip quietly back into the confines of a $250 to $300 trading range? (Chart 8.)

The "commodity" fundamentals of this market certainly had nothing to do with the strength. Mine production continues to inch higher. In its most recent report, Gold Fields Mineral Services (GFMS) estimates that global output grew by 15 tonnes, or 0.6%, in 2001. This may not seem like much, but it is a source of disappointment for bulls who believed that low prices would eventually curb output.

Fabrication demand for 2001was hard hit by the economic slowdown, falling by 269 tonnes, or 7.2%, marking the second consecutive year of declining usage.

Unlike some other rallies, which were typically motivated by a specific event, this move in gold was inspired by a series of events that have the common theme of concern in the investment community over economic and financial developments around the globe. There are a number of issues in play, and there seems to be a consensus of what those issues are:

1. The Japanese banking crisis – Japanese investors have been turning to gold after losing confidence in the banking system and becoming nervous about the looming March 31 expiry of the blanket guarantee available on all bank deposits that the government instituted in 1996.

It sounds worse than it is. First of all, until April 2003, demand deposits will still carry the blanket guarantee. After March 31, 2002, all deposits will still be insured for up to ¥10 million. The protection will not be much different from that of Americans insured under FDIC.

In any case, Japanese depositors did embark on a gold shopping spree. The World Gold Council estimates that purchases of gold bars and coins in Japan were 43 tonnes in the second half of 2001, compared with 21.3 million tonnes for the first half of the year.

In itself, the amount is not overwhelming. The real impact of the Japanese-investor angle has been the psychological effect it has had on a market that is already on high alert for shakeups of sacred cows. This brings us to the second issue that has been associated with the strength in the gold market: Enron.

2. The collapse of America's 7th largest corporation – Investors were rocked not only by revelations of the alleged shenanigans at Enron, but perhaps even to a greater extent by the failure of the audit industry, which is expected to be a bastion of integrity. There is a fear that over-the-top, Enron-style greed may be repeated elsewhere

3. A revolution in the gold mining industry – One of the important influences on the bear market in gold has been producer hedging. Newmont Mining Corp.'s takeover of Normandy Mining Ltd. made the world's largest gold producer a non-hedger. Announcements that other mining companies, such as AngloGold and Gold Fields Ltd., would cut their hedgebooks as well provides further evidence that we have entered a new era in the gold industry. This has both short- and long-term bullish implications.

In the near term, there will be spurts of short covering; it is very likely that some of the current strength can be attributed to this factor as companies clean up the hedgebooks of recent acquisitions. More significant, though, will be the disappearance of an important source of supply, which in the last half of the 1990s provided an average of 344 tonnes per annum, or about 9% of total supply, to the market. The transition is already in place. GFMS estimates that the global producer hedgebook shrunk by 101 tonnes in 2001. This represents an estimated 3% of their entire hedgebook, which leaves a lot of short-covering to follow.

The US dollar has been very strong. On the one hand this

makes the rally in gold quite impressive. Europeans and Asians have not been discouraged by the rising cost in local currency terms. On the other hand, it is reasonable to assume that the traditional relationship between the dollar and gold will become a factor as the dollar continues to rise and makes gold prohibitively expensive.

This is particularly true in Japan, where gold has appreciated dramatically in yen terms over the past year (Chart 9). While the strong US dollar factor may yet prove to be an impediment to a bull market in gold, we would point out that past bull markets in gold were not necessarily rational. As such, investors may very well ignore the definitively bearish "commodity" fundamentals cited above as well as the currency problem.

In conclusion, we believe that this was not a single-event, headline-grabbing rally that will soon fade into oblivion. The market has already established a pattern of higher lows on pullbacks (Chart 8). The combination of a shift in investors' attitudes to the equity markets and the changing face of the mining industry has ushered in a new bull market. We expect the correction/consolidation to be followed by a powerful new upleg that will take out the October 1999 highs of $338 per ounce. *[February 14, 2002]*

STRATEGY: *Remain long April gold. Maintain stops at 260, close only.*

Chart 8 – Spot Gold

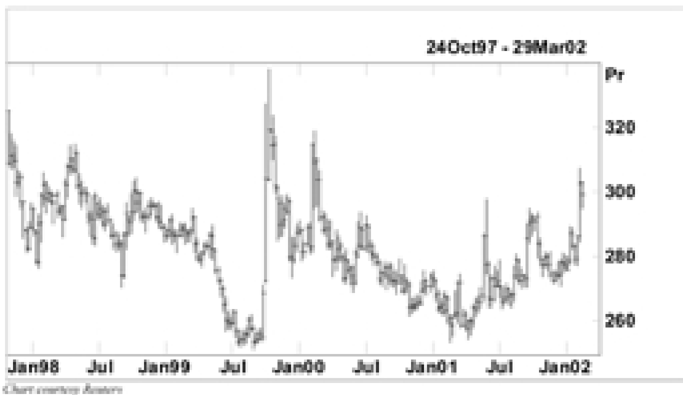
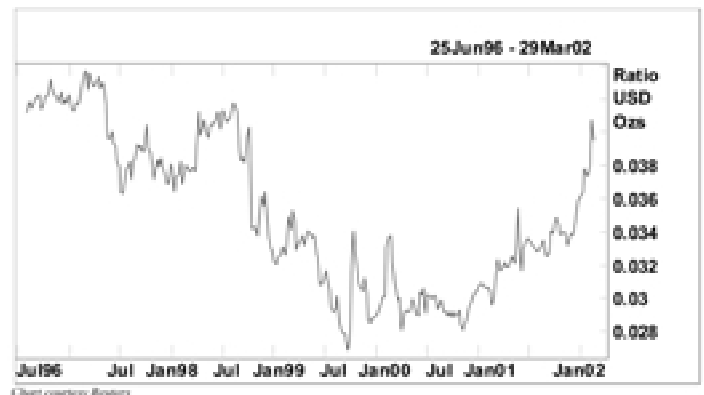


Chart 9 – Gold/Yen



GOLD

Central bank intervention?

Gold prices, already in the midst of a correction, took a curve ball from an unlikely source earlier this week. Ernst Welteke, president of the German Bundesbank, told Bloomberg Television that he could see the German central bank slowly selling off its 3,500 tonnes of gold reserves. Welteke's comment came as a surprise because the Bundesbank has stated specifically in the past that it would not sell any of its gold reserves. At the very least, the comments had some shock value, with gold prices closing out the session on the day of the interview down $5.30 per ounce. But does this apparent change of heart have any longer-term implications?

On the morning following the interview, a Bundesbank spokesman attempted to clarify Mr. Welteke's words. The spokesman explained that nothing was imminent, but the bank does not rule out sales when the 1999 Washington Agreement is renewed. In essence, the spokesman didn't tell us anything that we didn't already know. Those of the 15 signatories to the Washington Agreement that have participated in the program – primarily Britain and Switzerland – have all but used up the 2,000-tonne quota. None of the participants will be able to sell a single ounce above the quota until the first phase of the agreement ends in 2004.

If the Germans were to decide to change their policy on selling central bank gold reserves and jockey for position for a share of the quota in a renewed accord, it would not change the amount of gold sold by European central banks. As such, on the surface it is difficult to find a bearish subtext to the comments. The sudden announcement should not have any effect on the otherwise bullish environment the gold market is currently enjoying.

However – and it could be an important "however" – we should question the motivation for the remarks. Mr. Welteke certainly understood that his comments would create a stir in the gold market. If the Bundesbank can't sell any gold at this time anyway, why bother talking about it? There are two places to go with this.

First of all, it is well known that US Fed Chairman Alan Greenspan keeps a very close eye on the price of gold as a

barometer of inflation. Mr. Welteke may share those sentiments. Neither central bank chief wants to be put in a position of being forced to tighten monetary policy and stymie what looks like the beginning of an economic recovery. Mr. Welteke might have been using the media to test just how strong this rally in gold really is. The fundamental that is driving the rally – a shift in investor sentiment towards gold – might have suffered some damage.

Our second explanation might be more far reaching. Mr. Welteke may indeed be signaling a change of heart about the Bundesbank's attitude towards its gold reserves and giving the market a heads-up on its plans to participate in the next round of the Washington Agreement. Still, as we pointed out above, only the country doing the selling might change, not the amount sold. Or perhaps the quota will be increased. We've heard comments from an insightful economist suggesting that part of the Bundesbank's plan could be a push to expand the 400-tonne quota.

This could put a whole new spin on the market, reintroducing the problem that plagued the market in the first place. The Washington Agreement was probably the single most bullish event to occur in the gold market in recent years. Although European central banks continued to supply gold to the market, the market knew exactly what was coming. Before the Washington Agreement was in place, traders watched continuously for large, unannounced gold sales. The accord eliminated the uncertainty that fed the bear market.

We have no evidence that Mr. Welteke had such thoughts. On the other hand, central bank presidents are not known to publicize their idle musings. He meant to tell us something; these are some interpretations of his intended message. Either way, there could be bearish implications. Time will tell.

Not to worry. We haven't thrown in the towel, and we remain bullish. The market has now dropped over $15 per ounce from the peak it set earlier this month. A traditional reading of the open interest should be disappointing to bulls. During this $30-per-ounce rally, open interest jumped about 30,000 contracts, to just a tad below 150,000 contracts. The correction has seen the market shed a paltry 3,000 contracts.

Still, our reading of the open interest remains constructive, because we have not seen the earmarks of a stagnant market yet. Typically, the concern with a buildup in open interest lies in the belief that if a trend in price abates while open interest continues to build, the group that is responsible for the additional buildup – usually speculators who missed the train – do not have the ability to sustain the trend in price. In this case, the peak in the market coincided to the day with the peak in open interest. Although the open interest has not fallen very much, it stopped rising when the price stopped rising. We will identify a problem if the open interest exceeds the previous high of 150,000 contracts while the market languishes below the peak.

Another mitigating factor is that bull markets in gold are fueled by the investment community, small and large. As we've illustrated in recent issues, there is no bullish argument for gold if it were measured by the yardstick that we use to determine the fundamentals of other commodities. A buildup in open interest is arguably a bullish factor, so long as it remains within the parameters described above.

With our eyes open to developments that can affect this market, and until further notice, we remain resolutely bullish.

[February 22, 2002]

STRATEGY: *Remain long April gold. Maintain stops at 260, close only.*

Chart 10 – Spot Gold

COCOA

Can the cocoa bull hold on?

On February 19, E.D.&F. Man released its most recent report on the cocoa market. The size of the Ivory Coast crop is the single most important issue in this market. Man lowered its forecast for 2001-02 output by 15,000 tonnes from its December report, to 1.22 million tonnes. Overall though, the report was a disappointment for bulls. Although Man lowered the Ivorian figure, the reduction was less than we expected and forces us to take a closer look at our motivations for remaining long this market. The 2001-02 crop was expected to represent a continuation of a downtrend in production, but has turned out to be a fairly decent crop that will yield 35,000 tonnes more than last year's output.

Arrivals at Ivorian ports in December and January were running about 20% ahead of last year's pace, but it was a well accepted fact that the main crop season was going to tail off earlier than it usually does, which is indeed what has happened. Still, the performance of the main crop actually improved from Man's December outlook in which it spoke of deteriorating conditions.

The mid-crop was generally expected to come in between 150,000 and 200,000 tonnes. Were it not for a sharp downgrade in the forecast for mid-crop to 100,000 tonnes, Man's estimate for the total crop would have been higher than December's 1.235-million-tonne estimate. The multi-year highs in price we've been watching flicker across our screens would then certainly have been in jeopardy. Maybe they are.

Looking at other regions covered in its December report, Man raised its forecast for Indonesia by 25,000 tonnes, to 425,000 tonnes, despite reports of bad weather. Nigerian output was raised by 20,000 tonnes, to 170,000 tonnes.

The big downward revision was for Ghana, where Man lowered its estimate substantially, to 375,000 tonnes from 435,000. The Ghanian revision should have no effect on the market, though, because it was well known. For that matter, Man's estimate was about 20,000 tonnes higher than we've been hearing over the past few weeks.

The consumption picture provides no comfort for bulls. In our last discussion of the cocoa market, we questioned Man's pessimism about demand, primarily because spreads were so wide it was difficult to entertain any explanation for the market's strength other than the existence bona fide tightness of near-term supplies. With the market in backwardation, we reasoned, the legendary burdensome inventories must have been worked off. Man, however, argues that plunging cocoa processing margins, which are at historically low levels, will ensure that grindings remain weak. Man estimates that world grindings will fall to 2.937 million tonnes for 2001-02, down 108 tonnes, or 3.5%, from the previous season. While this still leaves a production/consumption shortfall of 136,000 tonnes, the estimated deficit is below Man's previous estimate of 150,000 tonnes.

We have established a long-term bullish bias, based primarily on the belief that the era of continuous growth in Ivorian production has ended. We do not want to be shaken out by minor, counter-trend moves, but we must note some concern about Man's assessment of the situation. Even after a sharp pullback in prices of about $100 per tonne, the market is 60% above the autumn lows from which this rally began (Chart 11). Given the bearish tone of Man's report, it would seem that the price is not necessarily current with the fundamentals.

We continue to believe that the market's strength – particularly in light of the fact the backwardation remains intact – tells us a lot about the fundamentals. To determine the source of the buying power that has kept the bull run alive, we must apply a stringent test to the speculative element.

Open interest has been relatively contained, which tells us that the speculative community has not really bought the cocoa story. The recent pullback from the highs was accompanied by an 8,000-contract drop in open interest. Even at the peak of 104,000 contracts, the open interest was very modest compared with the historical levels.

Furthermore, an examination of the Commitment of Trader data confirms that speculators have been very cautious on the long side. The largest net-long position commodity funds have held during this rally was 9,227 contracts. As of the most recent reporting period, commodity funds were net long 8,948 contracts. Not a huge correction, but headed in the right direction.

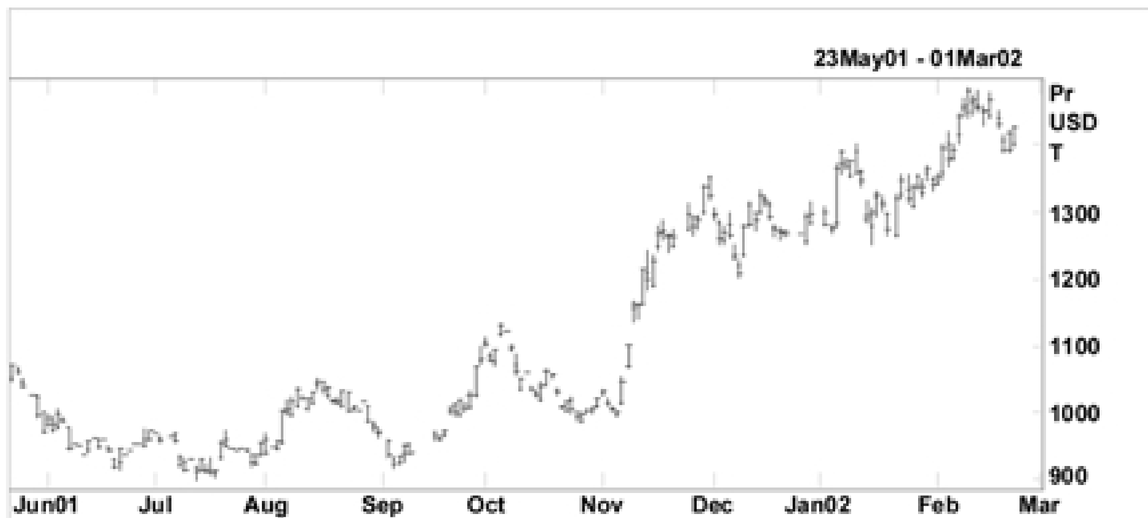
It seems, however, that when commodity funds were short, they were more eager. In June when the market was trading at around the $900-per-tonne level, commodity funds held a net-short position that reached as high as 16,648 contracts. The bulk of that position was accumulated at prices below $1,100 per tonne. The current, far more powerful, $500-per-tonne upleg has attracted a far smaller speculative contingent, which leads us to believe that commercial buyers are behind this bull market.

If the fundamentals are truly more bullish than Man's new set of data indicates, we should see commercial support on dips, which has been the pattern.

Again, we cannot ignore the data that show a market far less tight than we had believed it would be at this point. We recommend that bulls maintain moderate-size, sustainable long positions. *[February 25, 2002]*

STRATEGY: *Remain long September cocoa. Maintain stops at 1250, close only.*

Chart 11 – May Cocoa



HOTLINE UPDATE

Friday, February 1, 2002:
Good afternoon for Friday, February 1, 4:35 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long April gold, with our stop at 260; long May cocoa, with our stop at 1250; and short March mini S&P, with our stop at 1179. All stops are close only.

Friday, February 8, 2002:
Good afternoon for Friday, February 8, 4:40 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long April gold, with our stop at 260; long May cocoa, with our stop at 1250; and short March mini S&P, with our stop at 1179. All stops are close only.

Friday, February 15, 2002:
Good afternoon for Friday, February 15, 4:35 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long April gold, with our stop at 260; long September cocoa, with our stop at 1250; and short March mini S&P, with our stop at 1179. All stops are close only.

Friday, February 22, 2002:
Good afternoon for Friday, February 22, 4:05 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long April gold, with our stop at 260; long September cocoa, with our stop at 1250; and short March mini S&P, with our stop revised to 1140. All stops are close only.

Friedberg's Focus on Futures is published by Friedberg Commodity Management Inc., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3. Contents copyright © 2002 by Friedberg Commodity Management Inc. All rights reserved. Reproduction in whole or in part without permission is prohibited. Brief extracts may be made with due acknowledgement.

Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 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
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1910
New York, N.Y. 10005
(212) 943-5300

All statements made herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate.
Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

The U.S. broker-dealer, Friedberg Mercantile Group, Inc. NY, takes full responsibility for the contents of this market letter.
U.S. residents wishing to effect any transactions in any security discussed in this report
should contact Friedberg Mercantile Group, Inc. NY, toll-free at 1-800-474-2663.