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FOCUS ON FUTURES

Friedberg Commodity Management Inc.



Volume 6, No. 2 March 3, 2003

Copper: moving towards a balanced market

Copper prices continue to disassociate themselves from the trend in the stock market (Chart 1). For quite some time, movement in stock indexes seemed to dictate the direction of copper prices, often on a tick-for-tick basis. We are now in an environment in which this relationship should arguably be more logical than it was in 2002. The stock market is trading at five-month lows, in part because of the potential economic fallout that would result from a war in the Middle East, which would subsequently cut into demand for industrial commodities. In spite of this, copper prices have climbed to and consolidated around the 75¢-per-pound-plus level. Copper prices are hovering just below multi-year highs, while stock prices are hovering just above their multi-year lows.

The market is also holding up well despite the February 10 release of a somewhat bearish report by the International Copper Study Group (ICSG). After several months of deficits, November showed a 38,000-tonne global production/usage surplus. For the January-to-November period, the surplus jumped to 105,000 tonnes, compared with near-balanced market conditions at the end of October, when there was a tiny 6,000-tonne surplus. But the market remains considerably tighter than it was at this time last year, when we were sitting on a burdensome 536,000-tonne surplus.

As we noted last month, we have likely seen the end of production cutbacks. For 2002, Chilean production was down 2.9%, which was the primary reason for the move from the large surpluses of 2001 to a near-balanced market in 2002. In 2002, output fell in almost every month at Escondida, the world's largest copper mine. Evidence that this trend has reversed could be found in the February 13 release of data, showing that January output at Escondida jumped by 26.6% over January 2002.

The big question then is this: Is usage strong enough to sustain the move towards a balanced, and perhaps a deficit, global copper market?

This will of course depend on economic growth in the US, the EU, Japan, and China. The former three regions saw

consumption fall or stagnate in 2002. Using consumption patterns of the past few months to estimate 2002 demand, the EU and Japan will have equalled their 2001 usage. But in the US, usage fell 6%.

With the Chinese economy growing about 8% per annum and the development of massive infrastructure projects expected to continue, usage should expand further into 2003. China's mine production has stagnated at about 500,000 tonnes per year, but with demand increasing rapidly, its import needs will only intensify. In 2001, demand jumped by 433,000 tonnes, or 23%, over 2000, to 2.3 million tonnes. Through November, 2002 usage grew by 160,000 tonnes over the same period in 2001. If December usage reaches even the smallest monthly tally of the past few months – a bit over 200,000 tonnes – 2002 usage will have grown by 360,000 tonnes, or 15.5%, to 2.68 million tonnes. Incidentally, this would displace the US as the world's largest consumer of copper.

Chinese imports in 2003 are expected to exceed the robust pace of 2002. While it can be argued that China's

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

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economy – at least to some degree – can operate independent of growth in the rest of the world because of its vast domestic market, it is difficult to make the assumption that it can shoulder the burden of keeping the market balanced on its own.

ICSG data show that average demand in the EU and Japan has increased over the past few months compared with patterns seen earlier this year. US consumption has been flat. Still, even with a modest 3% increase in usage in these three regions, the anticipated recovery in mine production could easily be absorbed.

Movements in exchange warehouse stocks, a proxy for monitoring global inventory levels, have been consistent with the bull run that began last fall. In total, LME, Comex, and Shanghai stocks have fallen by about 350,000 tonnes, or 20%, since their 2002 peaks.

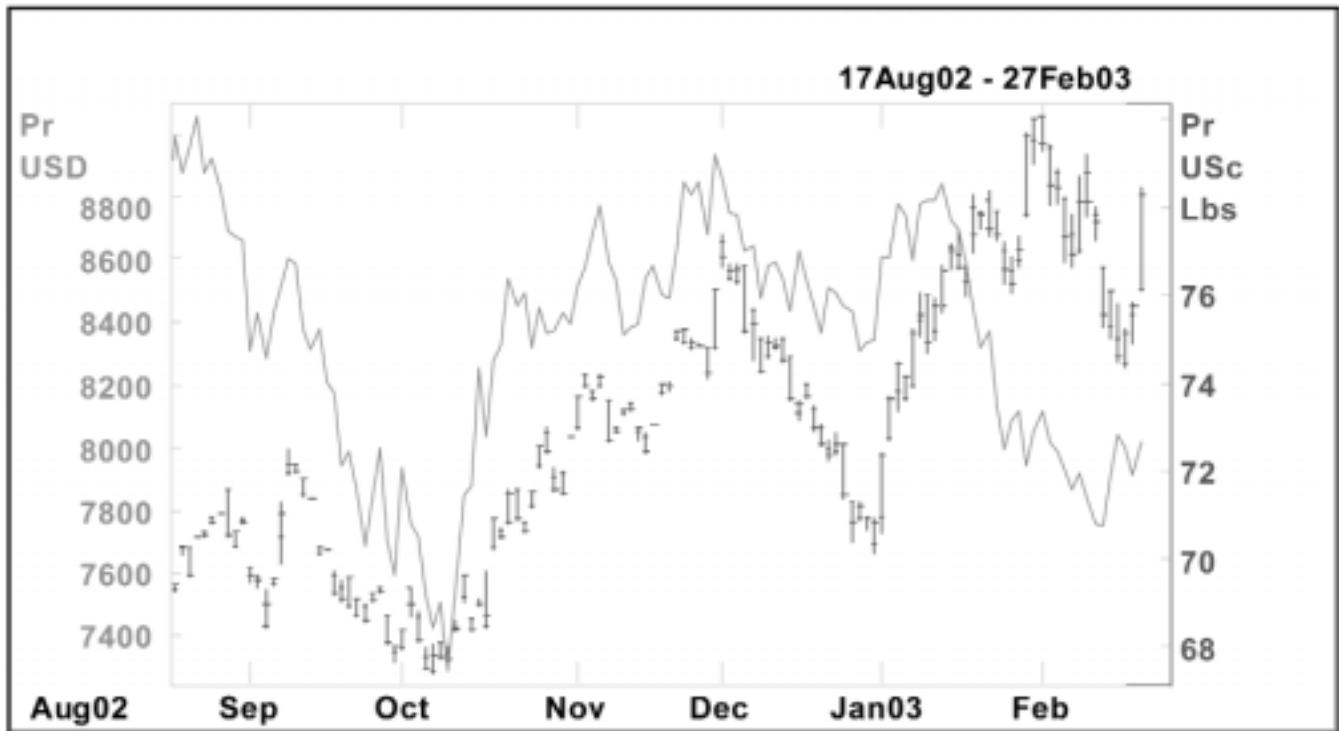
The copper market is in transition. It has emerged from the early-decade economic slowdown and has used up most of the excess inventories. We've identified the two principal

issues that have contributed to the improved balance sheet, namely production cutbacks and Chinese consumption. The cutbacks are history, but strong Chinese usage endures. Market action seems to indicate that Western economies are strong enough to replace the bullish effects of output curtailments.

We viewed the recent dip in the market as an opportunity to place our bets in the direction of the trend. To be sure, we have plenty of company. Even after lightening up by 3,389 contracts, this past Friday's Commitment of Traders data show that commodity funds are net long 26,527 contracts. Still, we feel that the market has risen because of sound, bullish supply/demand fundamentals, and – for the moment – we are not uncomfortable with the speculative company. *[February 24, 2003]*

CURRENT STRATEGY: *Remain long May copper as per Flash Update of February 13. Raise stops to 74.50, close only.*

Chart 1 – May copper (bar), Dow Jones Industrial Average (line)



Courtesy Reuters

SUGAR**Sugar powers ahead, but can it last?**

The bull run in sugar has now extended itself to the 9¢-per-pound level. And we'll tell you right off the top that this is beyond where we thought it could or should go. Still, the extraordinary rally in the face of very ordinary bullish fundamentals needs to be explained.

In 2000, sugar prices moved from below 5¢ per pound to 11¢ per pound. Early forecasts that season for below-normal crops in key producing nations like Brazil and Australia resulted in estimates for a 5-million-tonne production/consumption deficit. As the marketing year wore on, each new estimate by the major sugar analysts would bring revisions that narrowed the deficit by 500,000 or 1 million tonnes until we had no deficit at all.

Still, prices trended higher. In fact, when the final tallies were in, the 2000-01 season actually had a small surplus. Astute observers would have followed the revisions carefully and concluded that the rally could not last. In fact it did not, and over the course of 2001 the market worked its way back to the 6¢ per pound level.

We are watching a similar process (but in reverse) unfold in the current environment. We began the marketing year with estimates of a 5-million-tonne surplus. Each revision by the International Sugar Organization (ISO), Czarnikow, and F.O. Licht has trimmed the surplus.

Over the past 10 days the following data were published: Czarnikow lowered its estimate for the global sugar surplus to 2.13 million tonnes from its November estimate of 2.636 million tonnes, which was already down from an estimate for a huge surplus of 4.22 million tonnes at the beginning of the season. The ISO forecast a 2002-03 surplus of 3.283 million tonnes, down from its November forecast of 4.362 million tonnes. Finally, F.O. Licht raised its production forecast by 1.2 million tonnes from a previous estimate. There were no demand figures in the Licht report, so the implications are not as conclusive as the others mentioned. In any case, all these statistics point to a market that is tightening.

So while we learned from the 2001 experience that the market will eventually move in the direction of the revisions, should we not be applying the same principle here and assume that the market should continue to strengthen?

The bullish case can be made even stronger when looking ahead to the upcoming 2003-04 crop year. Brazil is the world's largest producer and exporter of sugar. In 2002 the country produced a record 22.7 million tonnes of sugar, roughly 16% of the world total. More important, however, is that Brazil exported close to 14 million tonnes, representing over 30% of world trade. Brazil is also the world leader in consumption of ethanol that is used as a gasoline mix.

Although the sugarcane crop is expected to increase by 5%, commitments by industry to increase production of

ethanol are expected to reduce export availability by as much as 4 million tonnes, according to one analyst. The Brazilian situation can single-handedly move the global market from surpluses to deficit.

But before we get too caught up in a bullish frenzy, let's check a couple of other factors. Sugar grows almost everywhere in the world. It is grown in the Northern and Southern hemispheres, so there is always an exporter somewhere in the world harvesting sugar. This is very much unlike cocoa, for example, where close to half of world supply is limited to one geographic region. Besides, global ending stocks of sugar are over 40% of consumption, and even a small surplus means an increase to ending stocks.

The ISO's 1.079-million-tonne downward revision to the global surplus consisted of a lower production estimate. The smaller surplus was the result of a 1.029 increase in the estimate for consumption, 600,000 tonnes of which is attributed to China. On the surface it would seem that this should be bullish in terms of expectations for China to be active in the import market.

China was required to import 1.64 million tonnes of sugar in 2002 and a further 1.852 million tonnes in 2003 to meet its WTO membership requirements. But in 2002 it turned around and exported 600,000 tonnes of its foreign purchases, indicating that its needs are not pressing and that its importing activities have been carried out largely to satisfy (albeit technically) WTO guidelines.

Domestic consumption may very well be rising, but China produced a record crop this past season, and there is no evidence that it is not in a position to meet its own needs with its own output and minimal imports.

We agree that the market has tightened as illustrated – with shrinking surpluses – but prices are now at one-and-a-half year highs, and we will still be left with a surplus. The ISO points out in its report that the *trade* surplus, which ultimately is the most important indicator of import demand, is still 2.802 million tonnes.

Part of our motivation for being skeptical about this bull run is the composition of the open interest, which tells us that the move was fueled by speculators. Even after a substantial liquidation of 30,000 contracts, open interest stands at a record 245,000 contracts. Last week's Commitment of Traders report shows that commodity funds and small speculators are still net-long 102,733 contracts.

We've made a few attempts at fighting the tape in this market over the past few months, and as usual the tape won. For now, we are on the sidelines, but we are looking to be short.

[March 3, 2003]

STRATEGY: *Remain sidelined, but stay tuned.*

COTTON**Breaking into new territory**

This past Friday, May cotton settled at 58.29 per pound, a contract high and the highest spot price in 2 years. This represents a better-than-100% rally off the unsightly lows of 28¢ per pound touched in the autumn of 2001. Supply and demand side fundamentals have both contributed to this powerful bull run.

Global production in the 2001-02 season soared to a record high of 98.35 million bales. In 2002-03, however, output in major producing nations nosedived, yielding a global crop of 87.64 million bales, 10.8% smaller than the previous year. Consumption, on the other hand, continued to increase during this period, growing 2.5% in 2001-02 and a further 2.4% in 2002-03. Total global demand for 2002-03 of 96.77 million bales outstrips new supply by a wide margin of 9.13 million bales, drawing down what were, not so long ago, burdensome global inventories.

The February USDA supply/demand situation report increased estimated production by 240,000 bales, but raised the consumption estimate by a like amount. Ending stocks were revised a notch downwards to 37.85 million bales, leaving the stocks-to-consumption ratio at a marketing-year low of 39.11%. The last time global ending stocks were anywhere close to these levels was in the first half of the 1990s, when endings stocks averaged 37.6% of consumption and prices ranged between 50¢ and \$1 per pound.

In looking at some of the specific areas that will affect the big picture and that should be monitored, we find domestic demand in the US a bit soft. Mill use has been in decline since the 1998-99 season, because manufacturing activities have shifted overseas to cheaper labor markets. In the February USDA report, the estimate for mill consumption was raised by 100,000 bales, to what will still be a modern-history record low of 7.6 million bales. This past week's National Cotton Council report, however, said that based on more up-to-date figures, mill use will reach only 7.35 million bales, below the low end of analysts' estimates of 7.4 to 7.7 million bales. A single-session bout of selling greeted this report on what was perceived to be an overbought market, but in the following session, traders ignored the domestic data and focused on global tightness that should persist even with falling US demand.

The data show clearly that the export market is compen-

sating for slumping US demand. Although the USDA has been forecasting all season long that US exports would fall just 200,000 bales short of last season's record exports of 11 million bales, the market was skeptical, because export commitments were running far behind last year's pace.

At this point, however, the USDA estimate for US exports of 10.8 million bales has become far more plausible. Although we are still running behind 2001-02 commitments, very strong sales over the past two months have closed the gap considerably. At the start of 2003, commitments stood at 6.9 million bales, 2 million tonnes behind the same time last year. This would have required weekly sales of roughly 130,000 bales before the marketing year ends on July 31. As of last week's report, commitments are only 1.3 million bales behind last year's sales, requiring only 70,000 bales of weekly sales to hit the USDA target.

Chinese output was revised upwards by 500,000 bales, to 22 million bales. Considering the pace at which consumption has been growing, however, it still leaves China with substantial import needs and was therefore not viewed as a bearish development. US sales to China have reached close to 1 million bales this season, while shipments are just shy of 600,000 bales. Although cancellations are always a fear for bulls, it should be noted that 2002-03 US shipments to date, represent more cotton than China imported all of last year from all suppliers.

We jumped onto the long side late last week. We've been waiting patiently for a substantial pullback, but it never materialized. At 88,000 contracts, open interest is not too far from its historical high of 95,000 contracts. To be sure, commodity funds and small speculators have built sizeable long positions, also equal to historical highs. For now, however, the open interest has behaved "well" in the sense that prices have not stagnated while speculators pile onto the long side. Typically, commercial traders will sell heavily when they believe prices are no longer commensurate with the fundamentals, capping the bull run. With world ending stocks tightening consistently, there is no indication that we are close to a top.

[March 3, 2003]

STRATEGY: Buy May cotton as per Flash Update of February 28. Place initial stops at 51.50, close only.

SOYBEANS**Is demand strong enough to keep the bull alive in the face of record South American crops?**

The soybean market has accomplished a monumental feat. In January, the release of the USDA monthly supply/demand situation report seemed to spell the end of what looked like a promising bull market. The estimate for 2002-03 US production was unexpectedly increased by 1 million tonnes. South American output – already at record levels – was revised upwards once again, with a 1-million-tonne increase to the estimate for the Argentinean crop. These revisions pushed ending stocks up significantly, to 30.65 million tonnes, or 16% of consumption, from the previous month's 15.4% of consumption. The market wiped out three months' worth of gains in a single session, and it looked as if that was the curtain call for bulls.

Despite the fact that the data have not changed very much since then, the market has come all the way back to the top of the range and this past week even traded briefly above pre-January-report prices.

The February USDA report did not provide much in the way of bullish data. The forecast for 2002-03 Brazilian production – which goes into harvest in early spring – was raised yet another 2 million tonnes. Combined, Brazil and Argentina will harvest 84.5 million tonnes of soybeans, 11 million tonnes more than last year. This surge in output displaces the US (74.29 million tonnes) as the number-one producer by more than 10 million tonnes. The market is obviously not fazed by this.

As robust as output growth seems, it is still being outpaced by demand. In 2001-02, consumption grew by 12 million tonnes, or 7%. This season, consumption is forecast to increase by 10 million tonnes, or 5.4%. Production rates grew at a slower pace. In 2001-02, output was up by 9.2 million tonnes, or 5.2%, while 2002-03 output grew by 8.58 million tonnes, or 4.6%.

Although the prospect for huge South American supplies becoming available in a matter of weeks hangs over the market, traders are focusing a lot of attention on the US situation. Despite the increase in the January estimate for the US crop, upwards revisions to US exports and seed use in February pushed ending stocks down to 4.48 million tonnes, or 5.9% of consumption. This puts US ending stocks back to early-season estimates that were as low as 5.8% of consumption, reminiscent of mid-1990s carryover levels, when prices spiked to

just shy of the \$9-per-bushel levels.

In addition, grain analysts argue that the USDA is being conservative about its 25.58-million-tonne estimate for US exports. Earlier in the season it was justified to assume that US exporters would not put in as good a performance as they did in 2002-02, because export commitments were running substantially behind last season's. At this point, however, even after several weeks of rather lame export sales, commitments are still running just 200,000 tonnes below the same time last year. The USDA estimate for the whole season still calls for exports to be more than 3 million tonnes less than last year. With 6 months left to the marketing year, this would translate into average weekly sales of less than 50,000 tonnes compared with an average of about 400,000 over the past 4 weeks.

The possibility of such a scenario unfolding, though, is not without merit. After a series of one-million-tonne-plus weekly sales tallies in November and December, commitments have declined steadily. And herein lies the bearish case. Bulls are assuming that since we've never seen US exports dry up so early in the season, it just can't happen. Well, the obvious counter to that is that the soybean market has absolutely no experience with competition. What happens when the US is no longer the world's largest producer? Importers could feel more comfortable delaying purchases, knowing that there is a mammoth crop ready to be shipped only a couple of months down the road. There should be some hesitancy by importers until it is clear that the flow of South American beans is not hampered by shipping problems – not an uncommon problem in Brazil. But once customers become confident, we could very well get a greater rate of cancellations than typical, particularly if South American prices remain competitive, as they are now.

The market has obviously chosen to work with the bullish case at the moment, just as we have. It's hard to argue with the trend. Having said that and taken a stance, we should also point out that we have respect for the very logical bearish case as well, and we have therefore become very cautious with this position by aggressively moving up our stop with the rally.

[March 3, 2003]

STRATEGY: *Remain long May soybeans. Raise stops to 562, close only.*

HOTLINE UPDATE

Friday, January 31, 2003:

Good afternoon for Friday, January 31, 3:35 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On January 29 we rolled over our long gold position, liquidating February at 370 and purchasing April at 371.10; we are currently long April gold at 371.10, with our stop at 315; and long July wheat at 311.50, with our stop at 2.95. All stops are close only.

Flash Update – Tuesday, February 4, 2003:

Good morning for Tuesday, February 4, 11:30 am. This is a Flash Update. We have purchased May soybeans at 564, placing our initial stop at 535, close only.

Friday, February 7, 2003:

Good afternoon for Friday, February 7, 3:35 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On February 4 we purchased May soybeans at 564; we are currently long April gold at 371.10, with our stop revised to 325; long July wheat at 311.50, with our stop at 2.95; and long May soybeans at 564, with our stop revised to 552. All stops are close only.

Flash Update – Thursday, February 13, 2002:

Good morning for Thursday, February 13, 10:10 am. This is a Flash Update. We have purchased May copper at 76.00, placing our initial stop at 72.00, close only.

Flash Update – Thursday, February 13, 2002:

Good morning for Thursday, February 13, 11:20 am. This is a Flash Update. We have liquidated our long July wheat position at 320. We repeat our update from earlier today, where we purchased May copper at 76.00, placing our initial stop at 72.00, close only.

Friday, February 14, 2003:

Good afternoon for Friday, February 14, 4:30 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On February 13 we liquidated our long July wheat at 320, and purchased May copper at 76.00; we are currently long April gold at 371.10, with our stop at 325; long May soybeans at 564, with our stop at 552; and long May copper at 76.00, with our initial stop at 72.00. All stops are close only.

Friday, February 21, 2003:

Good afternoon for Friday, February 21, 4:20 pm. The following is a recap of our latest recommendations and stop levels. We are currently long April gold at 371.10, with our stop at 325; long May soybeans at 564, with our stop at 552; and long May copper at 76.00, with our stop at 72.00. All stops are close only.

Flash Update – Friday, February 28, 2002:

Good morning for Friday, February 28, 12:55 pm. This is a Flash Update. We have purchased May cotton at 57.30, placing our initial stop at 51.50, close only.

Friday, February 28, 2003:

Good afternoon for Friday, February 28, 4:30 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On February 28 we purchased May cotton at 57.30; we are currently long April gold at 371.10, with our stop at 325; long May soybeans at 564, with our stop revised to 562; long May copper at 76.00, with our stop revised to 74.50; and long May cotton at 57.30, with our initial stop at 51.50. All stops are close only.

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Friedberg's Focus on Futures
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
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik
For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada M5J 2T3
1-800-461-2700

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