FRIEDBERG'S

FOCUS ON FUTURES

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Corn: big crops; demand, not so big

The 2004-05 balance sheet for corn is getting uglier for bulls. The Northern Hemisphere – where the vast majority of the world's corn is grown – is between crops, but the USDA continues to trim the demand side every month, which has resulted in upwards revisions in ending stocks. In its February supply/demand situation report, the USDA raised its forecast for global ending stocks by 2.3 million tonnes from its January report, to 117.27 million tonnes, or 17.2% of consumption. This compares with last month's 16.8%, and 15.1% at the end of 2003-04.

So the sharp drop in prices from the $3.30-per-bushel level we saw in 2004 to the current $2-per-bushel area was definitely warranted, but where do we go from here? Will we continue to see enormous crops that will eventually bring us back to the comfortable inventory levels of the 1990s, or was 2004-05 a flash in the pan?

While bumper crops in the US, China, and Europe eased the tightness we experienced during the 2003-04 season and caused prices to fall to multi-year lows, we should view the more relaxed attitude towards the inventory situation in a historical perspective. In the 10 years prior to the period cited above, global ending stocks as a percentage of consumption averaged 27.2%. Not only has consumption increased along with the bountiful crops, it has grown at a faster rate. Thus, even an encore performance in 2005-06 on the supply side does not necessarily ensure a sufficiently supplied market. Any meaningful uptick in demand would draw ending stocks down to the levels that we saw over the past two years and would create enough nervousness to drive prices back up.

Besides, yields for the US crop were so extraordinary this past season, it is a bit of a stretch to assume they could be repeated in 2005-06. The final yield estimate for 2004-05 was a record 160.4 bushels per acre, compared with 142.2 bushels per acre in 2003-04. There were only two occasions since the 1990-91 season when US yields grew for two consecutive seasons.

A USDA report released on February 11 confirms that we should not expect yields to be as high in 2005-06. The report forecasts that 81 million acres will be planted to corn, and 73.6 million of those acres will be harvested for a crop of 10.715 billion bushels. This implies that yields will drop substantially to 145.6 bushels per acre. It should be noted, however, that this report is quite preliminary, because it is not based on planting intention surveys. This year, this USDA report is particularly inconclusive because it does not include the possible acreage shift that may result from the soybean rust scare. This report is updated at the end of February, to be followed by the planting intentions report on March 31.

Government incentive programs are said to have inspired Chinese farmers to grow last season's large crop. A recent USDA attaché report, however, indicates that the programs played only a minor role and that it was high prices that motivated farmers. Chinese exporters have been slashing export prices to remain competitive, which we assume will ripple through to the domestic market and quash the incentive to devote excessive acreage to corn for the new crop.

Looking back to the demand side, the USDA lowered its forecast for 2004-05 US exports this month by a significant 1.27 million tonnes, to 48.26 million tonnes, which is about what US exporters sold in 2003-04. This is quite a disappointment from early on in the season when the USDA estimate was as high as 53.34 million tonnes. But commitments have been lagging. Even after last week's higher-than-expected sales of close to 1 million tonnes, commitments for the

Inside

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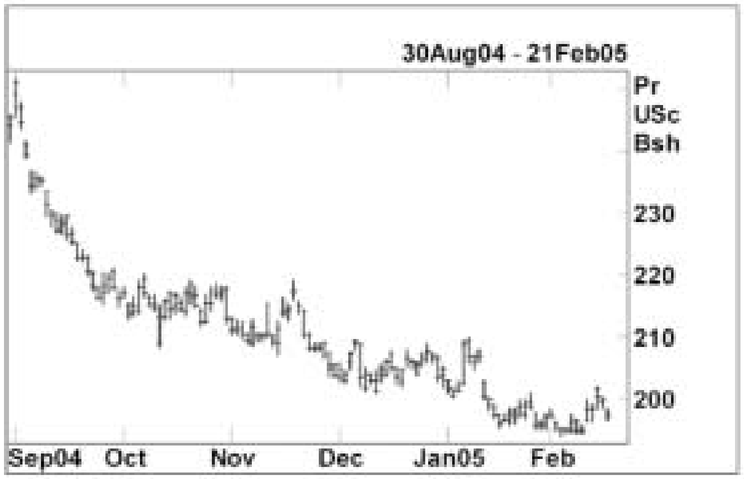
marketing year are running 11.3% behind last year at this juncture of the season.

Statistically speaking, the fundamentals are bearish across the board, as illustrated. Price, however, is at times the ultimate fundamental and could manifest itself in weak plantings and increased export demand.

Bearish as things may look, the risk/reward ratio is poor for bears, particularly with a huge speculative short position in the market, which makes the possibility of a powerful short-covering rally a continual risk. *[Feb. 17, 2005]*

STRATEGY: *Remain sidelined.*

Chart 1 – March corn



Courtesy Reuters

SOYBEANS

Can slipping South American output erode bearish sentiment?

After making fresh contract lows earlier this month, soybean prices have rallied more than 50¢ per bushel. Overall, the supply/demand fundamentals are quite bearish, but some recent developments are bullish enough to have justifiably sparked this rally.

In particular, it's been dry in South America during the key growing period, and the aggressive estimates that we've seen for the Brazilian crop are looking increasingly optimistic as they begin to slip. As it is, before the recent dry spell, the USDA lowered its Brazilian forecast in the February supply/demand situation report by 1.5 million tonnes, to 63 million tonnes. A February 14 USDA attaché report puts the crop at 61.8 million tonnes.

The USDA Argentinean estimate is 39 million tonnes, but the average of private forecasters' estimates is closer to 37.5 million tonnes.

Shades of last season? Final Brazilian output for 2003-04 was 52.6 million tonnes. But that was a drought-reduced crop. As late as February 2004, analysts were still forecasting a crop of 61 million tonnes. That crop failure didn't help prices very much, because the market was hit with a sudden drop in demand at that time, and the market was trading at over $10 per bushel. The current environment is completely different, mainly because prices have fallen dramatically, which makes the market more vulnerable to a supply shock.

Despite the downward revisions to 2004-05 South American production and the potential for further reductions, global inventories remain plentiful. The February USDA estimate was revised up from last month by 550,000 tonnes because of a series of small downward revisions to domestic demand in just about all importing countries except for China. This puts stocks as a percentage of consumption at 29.9%, compared with 29.18% last month and dramatically above last year's 20.4%.

After reworking these inventory estimates to reflect the probability that an additional 3 million tonnes will be shaved off Brazilian and Argentinean output, ending stocks would drop to 28.4%, which does not change the broader picture very much.

The USDA did not lower the US export estimate to reflect its downward revision in demand in importing countries. There were several weeks of reasonably good export sales, but commitment data show that although sales are higher than they were at this point last year, we're behind the pace required to meet the USDA target for annual sales. The forecast of 27.49 million tonnes is 12.5% higher than last year's final tally, but commitments are only 5% in front of same-time-last-year commitments.

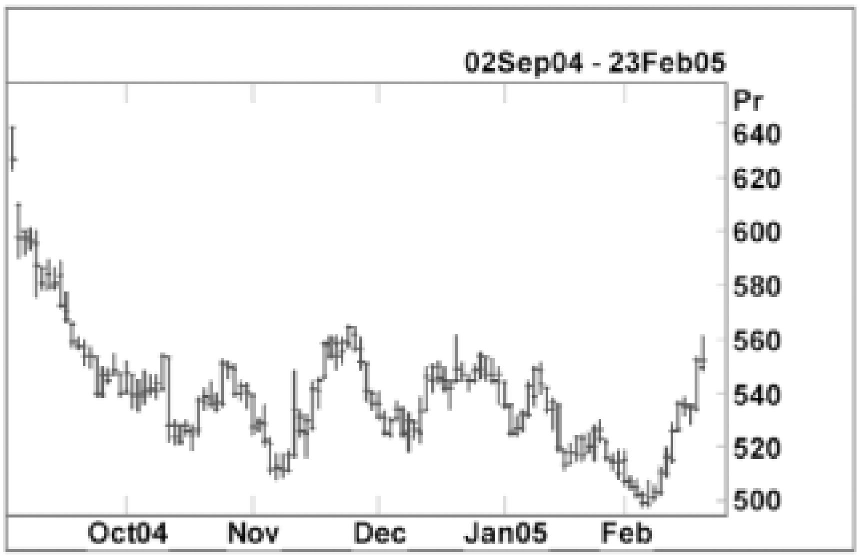
There is one short-term bullish factor. There is a very large speculative short position. Commodity funds are net-short 78,000 contracts and are feeling the pinch from the news of dry weather in South America. Funds have not been this short since 1998, and the possibility of a significant short-covering rally is definitely in the cards.

The effects of the arrival of rust in the US are unknown. Our first concrete glimpse of the consequences of the disease will not come until the March 31 release of planting intentions.

In conclusion, the numbers indicate that we're in a bear market all around. But soybean prices – as well as those of the other US agricultural markets – have already had steep declines, and the bearish supply/demand fundamentals may have partially or completely been accounted for. If South American output estimates continue to slip and/or US exports begin to catch up, higher prices are not out of the question. *[Feb. 18, 2005]*

STRATEGY: *Remain sidelined.*

Chart 2 – March soybeans



Courtesy Reuters

WHEAT

Has the era of declining production ended?

Our general outlook on the wheat market is similar to the view we presented on corn and soybeans earlier this month: a bearish balance sheet, but with prices low enough to assume that the bear case may already be built into the market. This leaves the market vulnerable to bullish surprises.

The February USDA supply/demand situation report was little changed from the previous month. A 1.3-million-tonne uptick for the estimate of global production was mitigated by a 1.27 increase in the estimate for global consumption. At 145.38 million tonnes, 2004-05 ending stocks represent 23.9% of consumption, unchanged from last month, and above 22.2% at the end of 2003-04.

A brief overview of the global picture: Production in 2004-05 took an extraordinary leap, breaking a 6-year-long string of shrinking crops. Output reached a record 622.19 million tonnes, a 12.5% increase over 2003-04 production. While we finally saw a recovery for all major producers (save for Australia), the fact that demand was climbing throughout the years of paltry crops should not be ignored. This year's improved inventory level is still well shy of the average global carryover of 31.3% of consumption we saw between 1990-91 and 2003-04.

The US export picture has improved steadily since earlier this season. This month the USDA raised its estimate for annual sales by 680,000 tonnes, to 27.9 million tonnes. We're still looking at much smaller exports than last year's 31.56 million tonnes, but with 15 weeks remaining in the marketing year, there is time for some catch-up.

Commitment data show that we're running 11.3% behind last year at this juncture, while the USDA estimate for the whole season is calling for an 11.6% drop in exports. This comparison seems to be splitting hairs, but average sales over the past 4 weeks have been 535,000 tonnes, and we need average weekly sales of about 300,000 tonnes for the balance of the marketing year to reach the USDA target. If commitments continue at their current pace, we can expect the USDA to raise its target again in March.

A key issue that traders will be focusing on increasingly in the coming weeks is the progress of the 2005-06 US winter wheat crop. In January, market participants were surprised by the planting intentions report. The average street guesstimate was for 43.2 million acres, but the actual figure was 41.6 million acres, close to 2 million acres below last year's plantings.

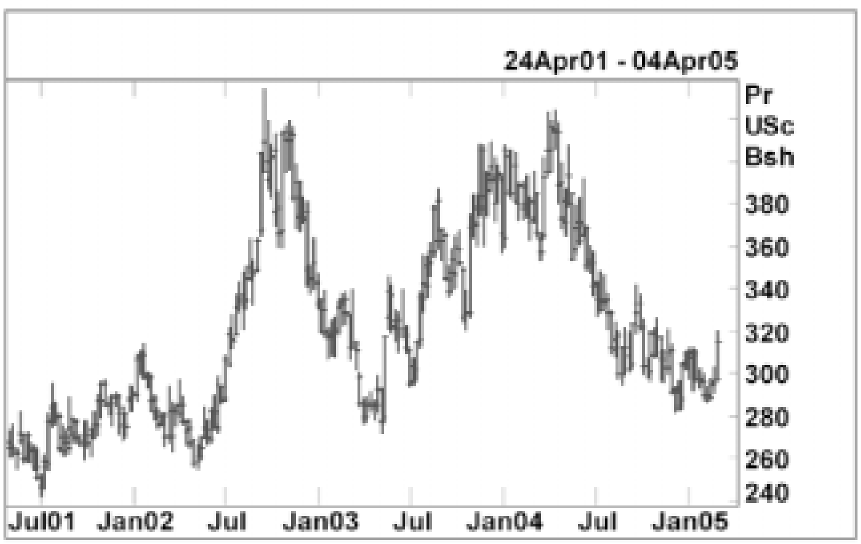
At this point in the growing season, there is not much available yet in terms of hard data on the progress of the crop. To be sure, there's ample anecdotal evidence of winter kill in some vital regions, but it is too early to tell. What is clear, though, is that based on the planting intentions report, the US is not participating in the global wheat production renaissance. So even if other producing countries have another bounty in 2005-06, the pool of food-quality wheat is still shrinking. This is particularly true in light of the fact that another high-quality wheat producer/exporter, Australia, had an off year as well.

Still on the 2005-06 crop, we typically don't see much talk about India's wheat market because it has not played much of a role in world trade over the years. For the most part, it has been self sufficient. This year, however, the Indian wheat market is expected to show a surplus of several million tonnes, and there is talk of participation in the export market. We do not anticipate that this will have any effect on US wheat prices. A USDA attaché report published on February 18 says that the government pays farmers a support price for wheat regardless of quality. This has enticed farmers to grow a lot of wheat, but quality – obviously – is not a primary concern. We therefore do not believe that surplus will in any way compete with US wheat.

Over the next two months, as Northern Hemisphere winter wheat crops mature, we will get a better idea of whether 2004-05 output was a single-year phenomenon or whether the trend of declining wheat production will return. Prices are cheap relative to where they've been over the past three years, but not so cheap if we have another year of bountiful crops (Chart 3). *[Feb. 25, 2005]*

STRATEGY: *Remain sidelined.*

Chart 3 – Nearest contract wheat



Courtesy Reuters

COTTON

The bear is history

While cotton was trading near its 42-cent lows over the past several months, we lamented over not having a short position. We were steadfast bears (see *Focus on Futures*, January 19). Having missed an ample supply of glorious selling opportunities, we exercised restraint and decided to wait for better selling opportunities. The market has now rallied 6 cents, and our sell tickets remain blank. Things have changed.

For starters, the US is not expected to repeat its 2004-05 production performance in 2005-06. The 2004-05 crop was (by far) a record 23.01 million bales. The USDA baseline estimate for planted cotton acreage in 2005-06 is actually expected to rise to 14.25 million acres, compared with 13.66 million acres in 2004-05. However, it is forecasting a smaller harvested-to-planted ratio, as well as lower yields, both of which were anomalies in 2004-05.

In 2004-05 farmers harvested 95.6% of plantings, compared with a historical norm of below 90%. At 846 pounds per harvested acre, yields were a staggering 15.8% above 2003-04 yields, also a record. If yields were to increase again in 2005-06, it would be only the second time in modern history that cotton yields grew for three consecutive years. The USDA is looking for yields to drop to 700 pounds per acre.

These estimates are highly preliminary, because they are based only on historical trends and macroeconomic conditions, but make no allowances for changing realities, such as atypical weather and farmer motivation related to price. This coming season there is an additional factor that could affect crop size – to the upside: The strong possibility of switching from soybeans to cotton in southern states because of fear of soybean rust. A clearer picture of the acreage matter will not be available until the release of the March 31 planting intentions report.

What has really driven this rally is the demand side. Early this marketing year, the USDA – very justifiably – forecast that US exports would fall sharply in 2004-05, after reaching a record 13.76 million bales in 2003-04. After all, China – the biggest buyer of US cotton – was going to harvest a huge crop of 29 million bales, up almost 7 million bales from 2003-04. At one point annual sales were estimated at only 11.3 million bales. But commitments have been very strong, and the USDA has raised its estimates almost every month throughout the marketing year. The February estimate was increased by an additional 300,000 bales from January and now stands at 13 million bales, exceeding even the most optimistic forecasts.

Indeed, Chinese purchases from the US are down sharply. As of this morning's weekly commitment report, China has contracted to buy only 1.397 million bales, compared with last year's purchases at this point of the season of 4.09 million bales. This means that demand from other US customers has replaced Chinese buying.

There was a downtick in the estimate for global 2004-05 ending stocks in this month's USDA supply/demand situation report, to 46.74 million bales, and an uptick in the estimate for usage. As a percentage of consumption, inventories now stand at 44.18%, compared with 45.12% in January and 36.15% in 2003-04 – still a burdensome stockpile. But the surprisingly strong surge in demand alters the landscape.

Much as we didn't want to chase the market down when we were bearish, we don't want to buy it poorly now that we're bullish. But it should be noted that commodity funds were heavily short and are just in the process of covering. Odds are that with May cotton having taken out a key resistance level at 49¢ per pound and the violation of a long-term downtrend (Chart 4), commodity funds will be getting long as well. We're looking to buy any reasonable pullback.

[Feb. 25, 2005]

STRATEGY: *Stay closely tuned.*

Chart 4 – May cotton

Courtesy Reuters

HOTLINE UPDATE

Friday, February 4, 2005:
Good afternoon for Friday, February 4, 4:25 pm. The following is a recap of our latest recommendations and stop levels. We are currently long May cocoa at 1530, with our stop at1450. All stops are close only.

Friday, February 11, 2005:
Good afternoon for Friday, February 11, 4:00 pm. The following is a recap of our latest recommendations and stop levels. We are currently long May cocoa at 1530, with our stop revised to 1410. All stops are close only.

Friday, February 18, 2005:
Good afternoon for Friday, February 18, 4:10 pm. The following is a recap of our latest recommendations and stop levels. We are currently long May cocoa at 1530, with our stop at 1410. All stops are close only.

Friday, February 25, 2005:
Good afternoon for Friday, February 25, 4:30 pm. The following is a recap of our latest recommendations and stop levels. We are currently long May cocoa at 1530, with our stop at 1410. All stops are close only.

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