FRIEDBERG'S

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FOCUS ON FUTURES

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On interest rates and inflation

Below, we excerpt portions of Albert Friedberg's letter to fund investors, written on January 8, 2006.

I continue to believe that interest rates are headed higher, though I am no longer as sure as I was that the yield curve will continue to invert going forward – or at least not for quite some time. Here's my reasoning: I expect that the global economy will continue to grow, allowing US exports to expand further and putting more strain on US capacity. With unemployment at 4.9%, the US is slowly moving to full capacity utilization. This is inconveniently timed with strong (and seemingly still rising) commodity prices and the probable end of the historically huge gains in productivity before it resumes its long-term pace of 1.5% to 1.7% per annum. (I don't know any more than anyone else, but productivity spurts of this magnitude, associated with technological breakthroughs, generally don't last more than a decade.)

I expect inflation therefore to grind its way higher, and move towards an unacceptable core rate of 3% soon after the present pause. The Fed, satisfied at the attainment of more "normal" rates and now data-dependent, no doubt will look at the stabilization of house prices as a cue to slow any further increase in the fed funds rate. In fact, I am quite certain that by spring at the latest, the Fed will pause to reassess the picture. This is because the FOMC is now tilted towards a more dovish view and is, of course, led by a renowned deflation-fighter.

David Rosenberg, the first-class economic observer at Merrill Lynch, recently noted that in the new line-up, the FOMC loses three hawks, gains one hawk, and adds one dove. This will not mean, as many are hoping, that the Fed will start climbing down by year-end. Very likely, it will stay on hold for some months. However, in our opinion, long-term rates will begin to reflect the new up-leg in inflation that we are expecting. By the end of the year, the Fed will resume raising rates, but this time the Fed's actions will lag market rates. In this scenario, there is a real risk that bond prices could fall hard.

Why are we so sure that inflation is going higher? Because US (and global) liquidity remains excessive even after this "dramatic" rise in rates. Only this excessive liquidity can explain the extraordinary rise in commodity prices, especially gold and other precious metals, record highs in world stock markets, incredibly narrow (and still falling) credit spreads, and the formation of new and huge private equities pools in the face of rising rates.

If real estate prices are softening, which we believe is true, it is only because they, more than in any other asset category, are a direct function of discount rates. As interest rates rise, regardless of liquidity conditions, real estate prices must begin to adjust to new returns. From being neg-

Inside

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

ative not long ago, real mortgage rates have climbed to somewhere between 1% (for the short-term adjustable kind) and 3.5%. In theory, rental properties can now trade between 10 and 30 times income, compared with the infinite multiples of yesteryear. So a cap on real estate prices is inevitable.

A cap is less inevitable for assets that do not trade as faithfully off income. The gradation, from assets most sensitive to discount rates to those least sensitive, is intuitive. Most affected are long-duration fixed-income for poor credits; next, the same for better credits. Then come blue-chip, large market-cap stocks for emerging markets, followed by the same in developed economies; speculative, low market-caps in emerging markets and, again, the same for developed countries; industrial commodity prices (affected by underlying economic cycles); and finally, precious metals.

Implications: Still bullish for TIPS (breakevens should expand). Another good alternative: Put money in short term Treasuries (6 months to 2 years) and keep powder dry for better opportunities in the bond market; stay away from long-term nominal bonds. Bearish for REITs and income producing real estate. Still bullish for non-income producing assets.

Gold

I remain very bullish on gold. Exploring and bringing new mines into production has become an enormously expensive, lengthy, and politically risky affair. Gold will have to attain much higher levels on a sustainable basis to reverse the present decline in production. From an investment point of view, the precious metal has come into its own as an asset class (some might say it has regained its status), displaying excellent returns over three and five years (48% and 89% respectively).

This is bound not to escape the attention of asset allocators, who now enjoy the luxury of betting on gold via a NYSE-listed ETF. Also, it should be noted that the enormous interest of pension funds in participating in commodities via fully paid futures (with cash earning money market returns) can have a significant impact on gold prices. Their investments recently reached US$100 billion to US$120 billion from less than US$40 billion two years ago.

Gold is one of the most liquid commodities traded on global exchanges and is likely to be over-represented if only by virtue of this liquidity and the perception that it represents a useful proxy for all commodities. Finally, it is well known that rising gold prices induce a sort of primal fear among holders of fiduciary money. Central bankers, being human beings, are almost certain to return to gold once the advance breaks through some psychological price barriers (round numbers like US$600, US$700, or US$800), and panic sets in.

To the puzzlement of most observers, gold accelerated its uptrend even as the US dollar strengthened (note that our long position was established against euros). The paradox, however, is readily explained. As long as the US dollar was falling, hard money investors were happy buying euros, Swiss francs, and yen. When the trend reversed, these visceral US dollar bears could not countenance buying dollars and hedging their depreciating assets. They turned to the next best thing, gold.

Implications: Need we say more?

– Albert D. Friedberg

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SUGAR

Sugar prices soar as ethanol steals market share

A summary of developments in the energy markets is imperative for understanding what's happening with sugar prices. Petroleum prices peaked this past August at precisely the same moment as devastating images of Katrina were being absorbed by frightened observers who were trying to come to terms with the fragility of a major American city, as well as the vulnerability of a huge chunk of the US petroleum-refining infrastructure. It was somewhat puzzling to watch prices tumble even while refining capacity was slashed overnight.

In its year-end review, API explains that although the US economy has – generally speaking – remained strong, high prices put a crimp on demand. In addition, there was a flood of imports in the wake of Katrina. Imports of petroleum products jumped to an all-time high of 3.48 million barrels per day. A sharp drop in crude prices ensued, aided in no small part by a rather mild Northern Hemisphere winter. Then a series of geopolitical matters involving key OPEC members once again cast a shadow of uncertainty over crude oil supplies.

The market has now climbed back to within striking distance of the $71-per-barrel high. Considering the record warm temperatures in some traditionally high consuming regions, which has allowed inventories of crude and distillates to build to multi-year highs, the fact that we are so close to the all-time high price is quite an extraordinary feat.

The relevance for producers and consumers of alternative fuels is clear. When crude prices plummeted by $15 per barrel between September and mid-November, some doubt may have surfaced about the need for large-scale investment into the development of commercially viable ethanol and biodiesel production facilities. Indeed, a careful study of Chart 1 indicates that the bull market in sugar took a break during the slide in crude prices. The powerful bull run resumed only after it seemed that crude had put in a bottom at the $55-per-barrel level.

The ability of the petroleum complex to recover in the complete absence of any bullish fundamentals to a level that is truly scary in terms of being potentially detrimental to the economy as well as in terms of inflationary implications should be enough to bolster the confidence of governments and private industry that are involved in the drive to expand the alternative fuel industry.

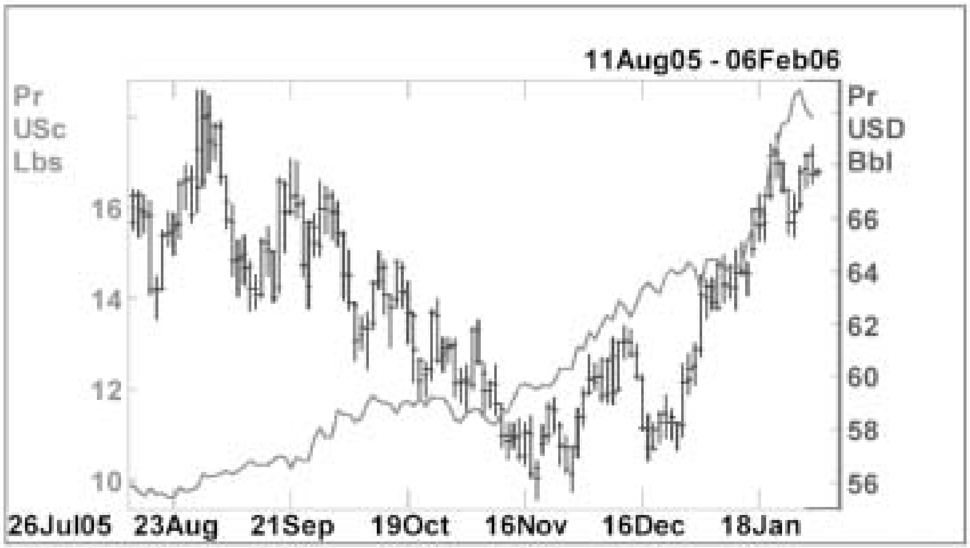
Let's now turn to more sugar-and-ethanol specific issues. Although the Brazilian cane crop to be harvested this spring will be a record, poor weather has reduced output estimates from early season forecasts. And it is quite clear that this is not something the industry can afford. The Brazilian government has in the space of just several years moved from mandating what percentages of ethanol *must* be blended with gasoline to its current role of issuing statements reassuring the public that imports will not be necessary. It also may need to lower the mandatory blend ratio. This past season, 52.5% of the cane crop was crushed into ethanol. Analysts now expect that figure to move up to 55% for the 2005-06 crop.

To get an idea of how ethanol consumption has permeated the market in Brazil, consider the following. "Flex cars" can run on any combination of gasoline and ethanol. This past December, Brazilian car dealers sold 183,000 flex-fuel cars, up from 158,000 units in November and 132,000 in October. December sales of flex fuel cars represented 71% of total sales, compared with only 29% in December 2004. The consumer has the option of what blend to use as long as it is above the government ratio. Although ethanol prices have increased along with petroleum prices, ethanol is still cheaper.

Early forecasts for the 2005-06 world sugar balance are for a deficit of about 2 million tonnes, following a deficit of 3 million tonnes in 2004-05. With all attention focused on Brazilian ethanol, we should not forget that both China and India are growing less sugar than they consume, and both countries have been eating into their inventories, which along with the drag on sugar availability from ethanol production, probably means that the 2-million-tonne deficit estimate will grow as the marketing year progresses.

We've entered a period of extreme volatility in sugar prices, and the next 2¢-per-pound can go either way in this type of trading environment. But the anticipated adjustment to sugar prices from the ridiculously low 5¢-per-pound level to reflect the new reality that sugar food usage will have to share the market with energy usage has arrived. Long-term traders who heeded our advice should have an adequate cushion with which to live through sharp dips. Remain long. *[Feb. 1, 2006]*

Chart 1 – Nearest contract crude oil (bar), nearest contract sugar (line)



Courtesy Reuters

COCOA

Turbulence in the Ivory Coast could translate into larger global cocoa deficits

Ever since civil unrest erupted in the Ivory Coast in 2002, the threat to the cocoa crop – growing it and getting it safely to port and out of the country – was largely an imagined one. The 2003-04 crop was a record, and although 2004-05 was an off year for output, poor weather rather than the unsettled political climate was the main cause. And perhaps the farmers and exporters will continue to muddle through. The events of the past month, however, may be an indication that the saber rattling may be advancing to more serious conflict.

Militants loyal to President Gbagbo attacked UN peacekeepers to protest the actions taken by a panel of international mediators. A new prime minister was "installed" by the panel with the intent of setting the stage for national elections. President Gbagbo's mandate actually ended in October, but he was allowed to stay in power on an interim basis until a new democratically elected leader was in place. The president is reluctant to hand over his powers, and the riots are viewed as a message to the unwelcome foreigners that his intentions are not likely to change in the foreseeable future.

Although it's hard to be certain, it seems to us that the potential for disruptions to the movement of cocoa has never been more real. Probably the most significant matter that can affect the industry is a labor shortage. Many Ivorian nationals have returned to their villages to protect their families and homes, and the attraction for foreign workers wanes when personal safety is a genuine concern. While most of the main-crop has been harvested and shipped, the smaller workforce could jeopardize the mid-crop.

Ivorian arrivals as of January 30 stand at 830,000 tonnes, still 23% ahead of last year at this time. The pace of weekly arrivals has slowed considerably over the past month. The reason for the slowdown is debatable. If the roadblocks set up by the militants and other such warlike activities have disrupted the flow of cocoa, then in all likelihood we're looking at a temporary issue. The beans are on the farms and will emerge eventually – that is, assuming the pattern of the previous seasons holds and those who have the ability to create chaos have a greater interest in assuring the country's largest export industry does not fall apart.

If, on the other hand, the below-average precipitation experienced over the past month is responsible, then we could be looking at a disaster. Even with a successful mid-crop, total output would fall far shy of estimates. It remains to be seen if arrivals pick up in the coming weeks.

At present, analysts are forecasting a 2005-06 global production/consumption deficit of about 100,000 tonnes. The expected drawdown is not painted as a very bullish factor, because everyone is quick to point out that burdensome global inventories representing 45% of consumption could be mobilized if a squeeze were ever to develop.

We've always been confused about those inventories, partly because of their unknown quality – some of it could be 10 years old or even older – and also for the simple fact that those ample inventories did not come marching to the rescue to keep prices from spiraling out of control to $2,400 per tonne in 2003. With no evidence whatsoever, we maintain a suspicion that the "burdensome inventories" are something of a myth.

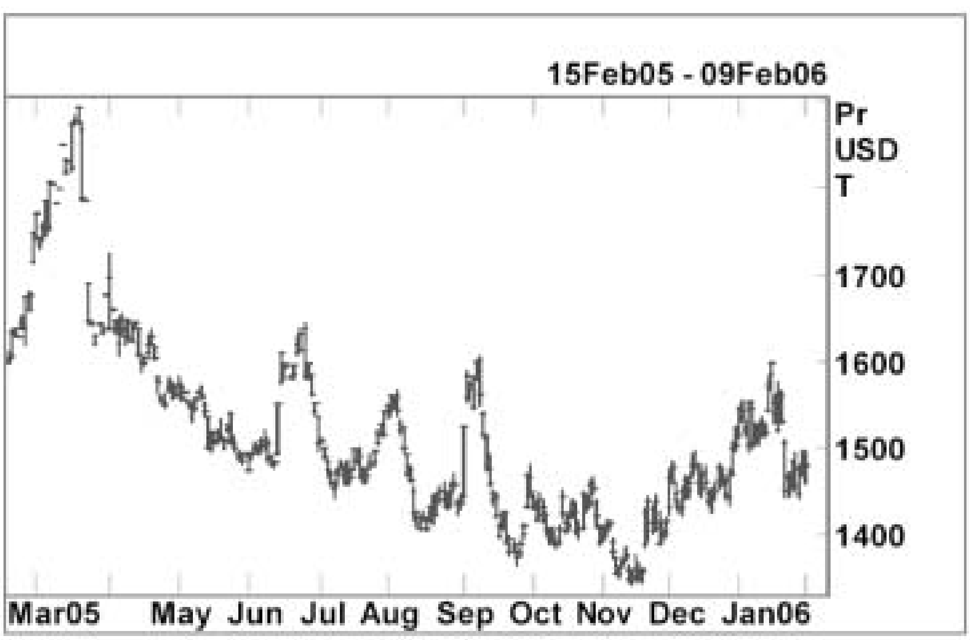
Nigeria, Ghana, and Cameroon, the other West African producers, all have plans to expand production, but none of those plans materialized for this season. The weather patterns are similar for the entire region, and all three countries are going to produce average-size crops at best. In Nigeria, cocoa arrivals are running 27% behind last year's pace, so it may not even produce an average crop.

The growing season is not over, but as illustrated, a comfortable supply side is far from a certainty. The demand side is shaping up nicely, though. Fourth-quarter grindings in Western countries were positive for the most part. Europe was up 4.7%, with Germany continuing its leadership, rising 23%. The US grind was disappointing for bulls, falling 2.2%. But it is clear that the shift of much grinding activity to origin countries, which we've mentioned many times, is underway. Brazilian grindings for 2005 reached levels not seen since its glory days of being the world's number two producer. Grindings totaled 216,0000 tonnes, the highest number since 1991. Malaysia is expected to grind about 250,000 tonnes, right near its grinding capacity.

A reasonable guess is that the Ivorian main-crop will reach 1-million-plus tonnes. With a main crop of about 200,000 tonnes and beans smuggled to Ghana that will never show up in any statistics, we would end up with total production of roughly 1.3 million tonnes – and that would be under optimum conditions. Any glitches to that model would be a surprise to the market. At the very least, the supply side is vulnerable.

Pardon the pun, but this market will grind its way higher when it becomes obvious that analysts have underestimated the global deficit. Maintain long positions. *[Feb. 2, 2006]*

Chart 2 – March cocoa



Courtesy Reuters

SOYBEANS

Healthy crops and sloppy demand keep prices tame

USDA statistics for soybeans released in January were not friendly for bulls. The 2005-06 US crop was revised upwards from the December estimate of 3.043 billion bushels (82.82 million tonnes) to 3.086 billion bushels (84 million tonnes). The average analysts' estimate was 3.065 billion bushels (83.51 million tonnes).

To put things in perspective, growing conditions in 2004-05 were as near perfect as you're going to see. Record yields of 42.2 bushels per acre brought a record crop of 3.124 billion bushels (85.01 million tonnes). In 2005-06, despite weather that was not nearly as cooperative and planted acreage that was 4% smaller than the previous season, US farmers harvested only 1.2% less soybeans than in 2004-05. The reason for the oddity is that at 43.3 bushels per acre, yields topped the previous year's record – a powerful testimonial to how quickly agricultural technology has advanced in creating hardy seeds that can grow plants that withstand periods of drought.

As a result, the quarterly stock report surprised the street with inventories of 2.502 billion bushels compared with analysts' estimates of 2.441 billion bushels.

The estimate for global ending stocks for 2005-06 jumped by 5 million tonnes, but only partly because of the fresh estimate of the US crop. Brazil did not sell as many beans as was previously believed and its 2004-05 carryover was revised upwards by 2.5 million tonnes. Global carryover stocks for 2005-06 are now forecast at 53.15 million tonnes, or 24.7% of consumption, up from 22.3% last month and compared with 21.8% at the end of 2004-05.

Chart 3 shows that although analysts were off with their estimates for the US crop and quarterly stocks, it was not a great shock. The market was already trading near the bottom of the range when the report was released, did not take out the November lows, and has since traded back to pre-report levels.

The most important issue that will guide the direction of this market in the coming months is the progress of South American crops. In previous issues we illustrated how the 2002-03 and 2004-05 seasons were marked by exuberant estimates for the Brazilian crop that reached as high as 66 million tonnes at one point. The reality is, however, that last year's record crop made it to only 53 million tonnes. Last January, the USDA was still listing 2004-05 Brazilian output at 64.5 million tonnes.

This year's estimates are somewhat more realistic. The USDA maintained its December estimate of 58.5 million tonnes for Brazilian output. There have been some hot and dry weather conditions in South America over the past few weeks, particularly in Argentina, where temperatures soared to 105 degrees, which, in all likelihood, saved the market from taking out those November lows. The extreme heat has let up, but the key growing regions in both Brazil and Argentina still need precipitation if there is any hope of achieving normal yields, which is what the current crop estimates are based on. This is the only potentially bullish angle we know of.

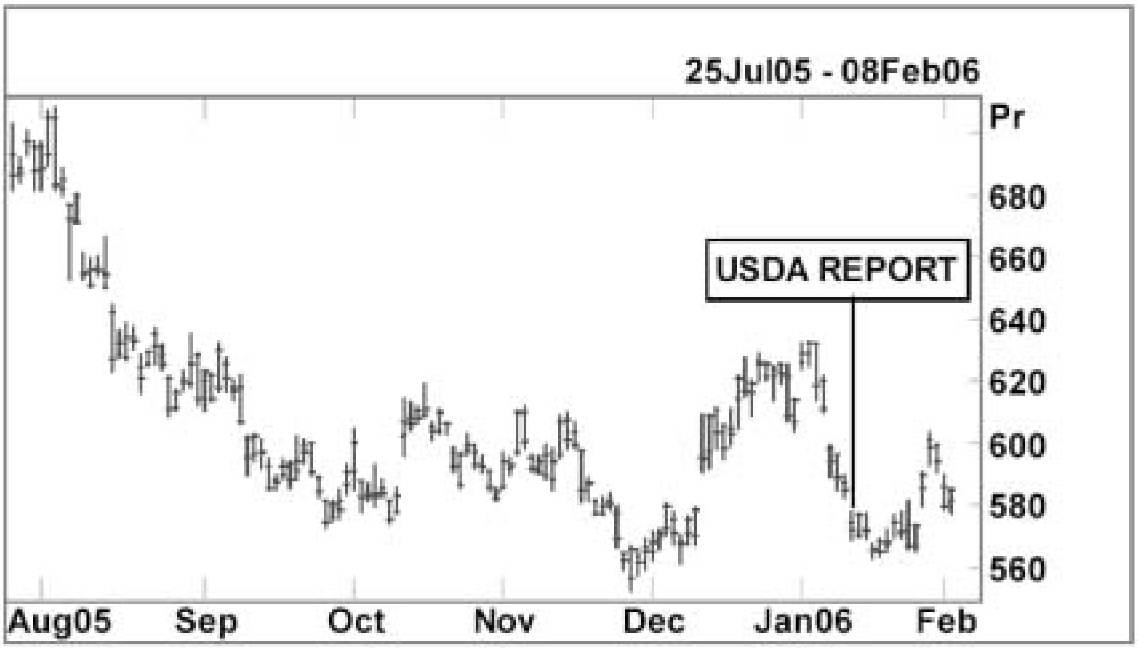
The demand side does not provide any relief for bulls either. The USDA estimates that 2005-06 US exports will be 13.8% smaller than last season, but this week's export report showed that US export commitments are running *23% behind* last year at this time.

Alternative fuels have received a lot of attention lately, particularly with the rally in petroleum prices after the Iran nuclear crisis began to make headlines. The bio-diesel market, in which soybean oil would be a large factor, is still in its infancy. The perception that a commercially viable infrastructure is developing, though, would certainly attract the interest of commodity funds, and rightfully so. For the moment, however, global usage figures indicate that whatever growth the soybean-oil-based bio-diesel market has experienced, it has not made an appreciable dent in world supplies. Global demand of soybean oil is expected to grow by 5.5% in 2005-06, but output will be keeping pace, growing by an estimated 5.2%.

We expect soybean prices to work their way lower, but we have little interest in being short when most commodity markets are in torrid bull markets. Any bullish news would surely spark a short-covering rally by commodity funds.

Stand aside. *[Feb. 3, 2006]*

Chart 3 – March soybeans



Courtesy Reuters

CORN

A bull market brewing

Corn prices have shown some signs of life lately, rallying to the highs of their recent range. A series of USDA reports released on January 12 actually painted quite a dismal picture – for bulls – of the global balance sheet. Although the reports contained bearish revisions for most key items regarding US supply and demand, the changes for the US side were relatively minor.

The quarterly stocks report showed that inventories of corn on December 1 were 9.813 billion bushels (249 million tonnes), above analysts' average guesstimate of 9.774 billion bushels (248 million tonnes) and higher than December 1, 2004, stocks of 9.451 billion bushels (240 million tonnes). The estimate for the US crop was increased slightly – the estimate for yield was lowered by 0.5 bushels per acre, but harvested area grew by 800,000 acres. Exports were revised down slightly (more on that later). Ending stocks are forecast to rise from last month's estimate, but only by a small amount.

At the global level, the estimate for ending stocks was increased by close to 10 million tonnes, to 128.26 million tonnes, or to 18.7% of consumption, up from 17.3% last month. Although that is quite a jump from last month, the world is still expected to consume slightly more corn than it produces this season, and stocks will therefore be drawn down further to remain below the 2004-05 level of 19.2% of consumption.

We are bullish despite these seemingly bearish statistical developments for three reasons.

First, US farmers will almost certainly plant significantly fewer acres of corn than last season. Of all major US crops, cornfields require the largest amount of natural gas-based fertilizer. With natural gas prices at all-time highs, whatever little profit there is in corn farming is squeezed right out of the farmer's pocket, particularly with corn prices so low. Now, natural gas prices have fallen substantially since mid-December, and the models that show how corn farmers barely cover their costs are somewhat outdated. But even at these prices, fertilizer is at historically high prices, and there is no guarantee that the bull market in natural gas is over.

Second, while natural gas prices may have experienced a sharp setback, petroleum prices have not, and the motivation for continuing to develop a corn-based ethanol market has never been stronger. Of course the ethanol market in the US is not a fraction of what it is in Brazil, but witness what happened with sugar prices when the food portion of the sugar market had to compete for supplies with the fuel market. The USDA estimates that 1.575 billion bushels of corn, or 14.6% of total US consumption (domestic plus exports), will be used as ethanol in 2005-06, up from 12.4% in 2004-05 and 11.4% in 2003-04.

Finally, the USDA revised downwards its estimate for US 2005-06 exports by 1.27 million tonnes, to 46.99 million tonnes, or 2.6% lower than last month's estimate. The estimate has been shrinking since early this marketing year when optimism ran high that exports would grow significantly over last year's 46 million tonnes. The estimate was as high as 50.8 million tonnes just two months ago. The USDA was justified in its pessimism, because sales were slow in the early going. Indeed, as recently as two weeks ago, export commitments were running 1 million tonnes behind the same time last year. But three consecutive weeks of extraordinary sales have turned this segment of the market around completely, and we are now running 1.3 million tonnes *ahead* of last year's pace.

Average commitments for the past 3 weeks were 1.586 million tonnes, compared with an average of 509,000 tonnes in the previous three-week period.

Commodity funds have not taken a ride on this train – yet. As of last week's Commitment of Traders report, they were long a paltry 4,000 contracts out of a total open interest of just under 1 million contracts. The rally off the bottom is a reflection of fundamentals in transition to the bullish side. We advise accumulating long positions. *[Feb. 3, 2006]*

Chart 4 – March corn

Courtesy Reuters

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