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Friedberg Mercantile Group Ltd. Volume 10, No. 1 February 5, 2007

Wheat: will the coming bumper crop end the bull market?

Back in October, wheat prices were extending multi-year highs daily. At the time, it seemed as though estimates for the Australian crop were falling by a million tonnes a day and that importing countries would soon be forming queues at US ports, scrambling for the last shipload of available wheat. Much higher prices were a sure bet.

Strangely, though, the anticipated demand from foreign buyers has not materialized. Exports have been sluggish. On January 18 traders were surprised by a much-higher-than-expected weekly USDA export report of 825,0000 tonnes. Until then, weekly sales had averaged only 452,000 tonnes since the first week of October.

The January 18 figure quickly proved to be an anomaly. The next weekly report showed that sales dipped to a well-below-average 246,000 tonnes. Prices have fallen by more than $1 per bushel from the peak, but the purported desperate buying that we believed would eventually appear has not.

In response to the bleak outlook for export activity, the January USDA supply/demand situation report lowered US exports for the marketing year yet again, to 23.81 million tonnes from 24.49 million tonnes in December.

For bulls, the window is slowly closing. Indeed, traditional buyers of US wheat have their requirements, but it would seem quite clear at this point that they have merely pushed off their purchases in the hope that the anticipated bountiful Northern Hemisphere winter crops would provide ample supply and lower prices. And at the moment, available evidence is telling us that this scenario might very well be unfolding.

The USDA's US winter wheat acreage report released alongside the monthly report showed that farmers planted 44.08 million acres, just a smidgeon below the average of analysts' estimates of 44.12 million acres. This is sharply above 2005-06 planted area of 40.6 million acres. Weather has been cooperative, so we should expect a good crop.

In looking at other key wheat regions, we find that just about all producing countries have responded to high prices and have increased acreage.

Notably, India is emerging from a sub-par crop year in which it produced only 68 million tonnes in 2006-07, and as a result imports of over 5 million tonnes were required. Plantings for the new crop to be harvested in March, however, jumped substantially and output is expected to reach a record 74 million tonnes or more. India will return to self sufficiency.

The International Grain Council released a preliminary estimate for global output for the 2007-08 marketing year of 621 million tonnes. The highly regarded industry newsletter *Price Perceptions* (January 6) is forecasting a global crop of 628 million tonnes. This will represent a 30- to 38-million-tonne, or about a 5%, increase over 2006-07 production. This is not a record and only ties 2004-05 global output. It is safe to assume that demand will expand, particularly because there is very likely a fair amount of pent-up demand from importing countries that have delayed purchases.

Global ending stocks for 2006-07 are estimated at 20% of consumption, the lowest inventory level in modern history. But that is old hat, and the market is expecting the balance sheet to improve with the large crops expected to be harvested beginning in a couple of months from now.

Certainly in terms of market action, one would have to

Inside

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conclude that the top is in. There are, however, issues that will not be resolved for a few months yet. We have no doubt that exports will pick up steam, particularly when importers begin to book new crop sales. Furthermore, it is absolutely essential that there are no climatic glitches. A crop failure in any key growing region will definitely send the market soaring to new highs and punish those importers who were complacent in using up their inventories and holding out for better prices.

For now, however, the market violated the $4.60 stop close basis the spot contract month we suggested on December 4. Prices have since rallied, fallen back, and seem poised to take out that level again. We continue to recommend the same stop for bulls who are still long. *[January 29, 2007]*

COPPER

Solid surpluses mark the end of the bull market

A dazzling set of economic data released on January 24 showed that the Chinese economy grew by a larger-than-expected annualized 10.4% in the fourth quarter and by 10.7% in all of 2006. Copper prices, which had already been bouncing off 10-month lows, extended their rally on the news, in the belief that Chinese imports would eventually resume the pace that pushed prices to over $4 per pound last May.

The rally fizzled as traders continued to focus on the steady flow of bearish statistics, which show that the global market is moving out of deficit and into a comfortable surplus.

Actually, one segment is still lagging and that is Chilean production. We assumed all along that the massive investment in infrastructure at several mega-projects in Chile would mean a continuation of a 10%-per-annum growth rate in output. Although the capacity certainly exists, labor strife and weather problems have kept production from reaching its explosive potential. The range of forecasts early in 2006 were looking for production growth for the year of anywhere between flat and 6%. With the December statistics in, output for the year finished at the low end of the range, with an increase of only 0.8%.

Any Chilean shortfall, however, is obviously being compensated for by mines in other key production regions such as Indonesia, North America, and the FSU, as well as by secondary production. Indeed, The International Copper Study Group (ICSG) estimates in its January 18 report that between January and October, total refined output has grown 6% over the same period in 2005.

The sharp increase in combined warehouse stocks in London, New York, and Shanghai, while by no means a leading indicator, is clearly commensurate with the dramatic drop in prices that we've seen over past few months (Chart 1).

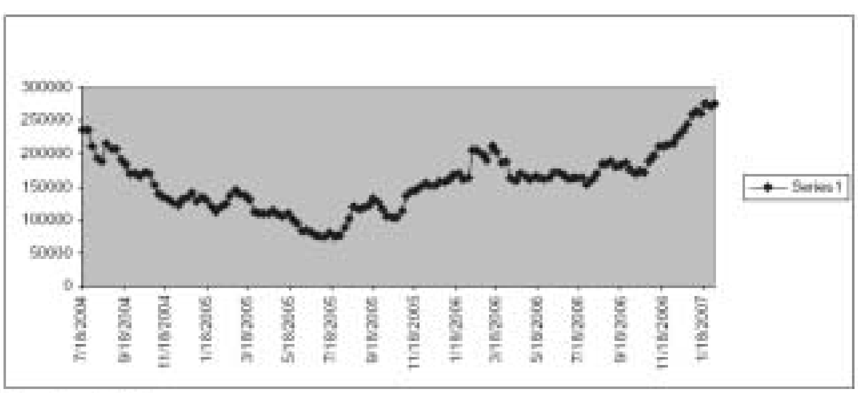
Charts 2 and 3 show that backwardation in both New York and London has completely disappeared, a fairly certain indication that whatever tightness existed is now gone, leaving the physical market well supplied.

ICSG says that the global balance sheet is now sporting a surplus that has grown to 128,000 tonnes for the January through October 2006 period. This is up from 81 million tonnes at the end of September and a dramatic swing from the 298,000 deficit for the same period in 2005.

Looking ahead, ICSG is forecasting that surplus markets will continue into 2007. There are forecasts calling for Chilean production to jump by close to 6%. We've seen how the market achieved a global surplus with flat output growth in Chile. If Chilean production were to meet these expectations, demand in China and elsewhere would have to increase by an extraordinary amount to draw this market back into deficit.

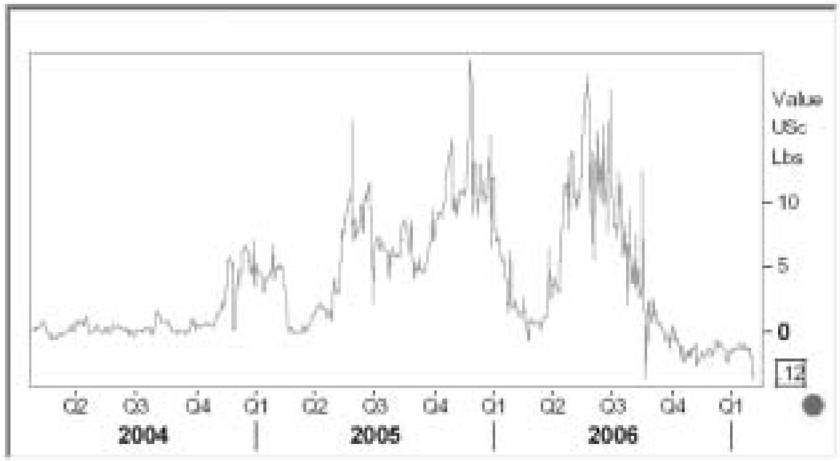
We maintain our recommendation of holding conservative short positions. *[February 2, 2007]*

Chart 1 – Global copper warehouse stocks



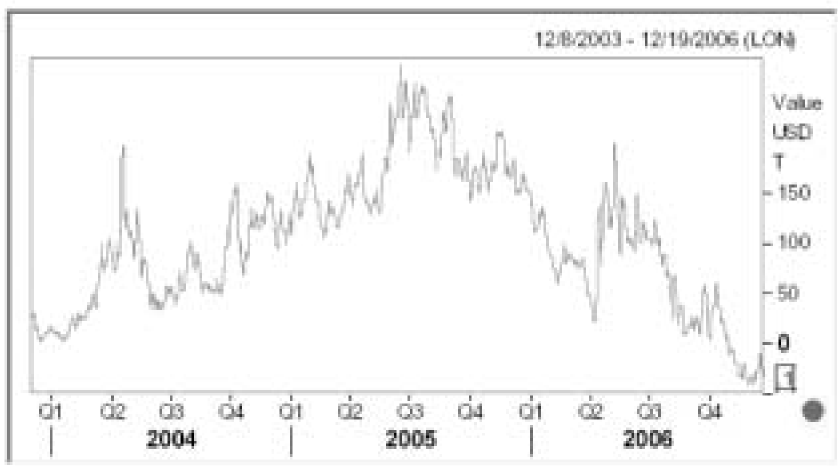
Courtesy Reuters

Chart 2 – Daily Comex front month to 3-month spread



Courtesy Reuters

Chart 3 – Daily LME cash to 3-month spread



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COCOA

Flat output plus growing consumption equals a bull

Cocoa prices soared to $2,400 per tonne in 2003, mainly because of worry that a civil war in the Ivory Coast would disrupt the flow of supplies from the country that grows 40% of the world's cocoa beans. Although the violence did cause problems in terms of migrant-labor shortages and the occasional road blockages, output has been consistent, which explains the implosion of the massive fear premium. The tensions have subsided, but have not disappeared. Still, there is obviously little reason to be bullish because of the political environment alone.

Actually, cocoa has been one boring commodity over the past three years. In an era of explosive moves in virtually every category of commodities – other softs, energy, US agriculture, metals – cocoa has traded mostly between $1,400 and $1,700 per tonne. There's been the occasional foray outside the range, but prices haven't gone anywhere.

An examination of the supply/demand fundamentals, however, reveals a developing bullish scenario.

As of January 28, total arrivals of 2006-07 main crop beans at Ivorian ports were 830,000 tonnes, about the same as last year at this time. The main crop harvest lasts until the end of March, and estimates are for output of 930,000 tonnes. If arrivals were to continue at the normal pace for this point of the season, this estimate would be achieved. Weekly arrivals were about 25,000 tonnes until recently, but they typically tail off sharply to below 10,000 tonnes per week. Weather has not been completely cooperative, and market observers are saying that quality is poor, which means smaller beans. So it is quite certain at this juncture that we will not equal last year's main crop that reached 966,000 tonnes.

More important, though, is that last year the Ivory Coast produced a truly extraordinary mid-crop of 400,000 tonnes. At this time last year we were very skeptical about estimates that were looking for a record mid-crop. But we were wrong. This year, however, nobody is even talking about that kind of mid-crop performance. It would be nearly impossible for the trees to produce those kind of yields in consecutive growing seasons. Using a generous historical average mid-crop of 250,000 tonnes plus a main crop of, say, 950,000 tonnes, our rough estimate for the total Ivorian crop would therefore be 1.2 million tonnes, significantly below the final tally for 2005-06 of 1.387 million tonnes.

None of the other major producing countries are picking up the slack. Neighbor Ghana is expecting a 700,000-tonne harvest, down from 740,000 tonnes in 2005-06. Extremely dry conditions in Indonesia for the tail end of its mid-crop mean it will likely see trend line yields at best.

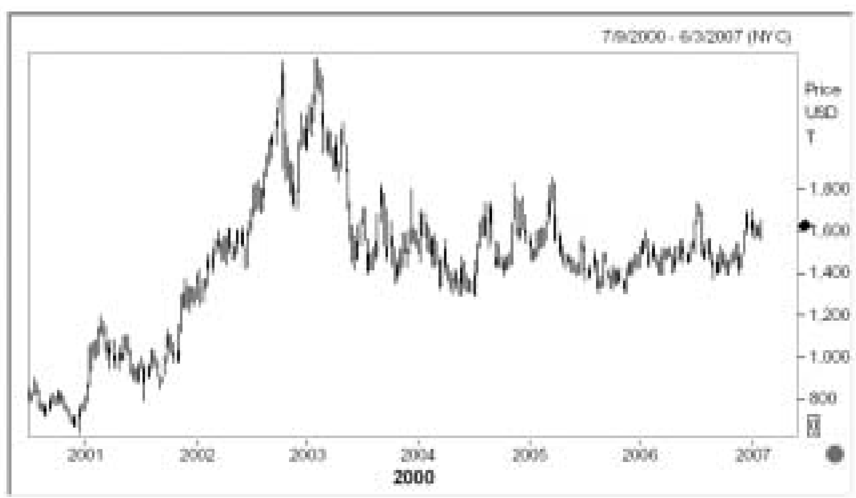
Of course, bears will counter by pointing to the legendary burdensome carryover stocks. Indeed, prices have been kept in check in years when we saw production/consumption deficits. The market could always count on sluggish demand growth, but we are once again seeing evidence of strengthening consumption patterns. Although we laid all blame for the run to $2,400 per tonne on political tensions, it is very clear that that bull run was also accompanied by strong demand.

First, fourth-quarter grinding statistics in the primary consumption regions were very impressive. The US grind was up 2.9% over fourth quarter 2005, while the EU grind was up a hefty 6.9%. In addition, European butter ratios have been quoted as high as 2.8 times the spot London price, the best level we've seen in a very long time.

A recent Reuters poll showed that all surveyed analysts are looking for a deficit, with the estimates ranging from 50,000 to 225,000 tonnes. With demand growing at 5% or more and production flat at best, we'll bet heavily on the side of the largest deficit forecast.

This market presents the opportunity for a relatively low-risk trade. We advise the purchase of May cocoa, with a $1,580-per-tonne close only stop. *[February 5, 2007]*

Chart 4 – Weekly nearest cocoa contract



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