FRIEDBERG'S
FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.

Volume 11, No. 1 February 12, 2008

If the economy is weak, what's keeping copper up?

Base metals are right near the top of the list of markets whose fortunes are (or should be) closely tied to the health of the economy. Historically, the stock market has served as a proxy for the economy in this regard, and copper prices – for the most part – have tracked the popular indexes. A closer look at recent activity, however, shows that there has been some divergence in this relationship. First, back in December, copper sank to 9-month lows while stocks were enjoying a sharp rally (Chart 1). More recently, copper prices have held rather well during a 1,500-point decimation of the Dow Jones Industrial Average.

Towards the end of 2007, prices were responding to what seemed to be developments that would ultimately spell the end of the bull market in copper. Warehouse stocks were building. The International Copper Study Group's (ICSG) monthly global balance sheet reports showed that the market started to inch its way out of deficit. With potential for tumbling demand caused by fallout from the collapse of the subprime mortgage market, the bear case was complete. From October through December, the market plunged by close to $1 per pound. Indeed, on January 21, the ICSG released its most recent report for January through October, showing that the deficit shrank even further, to 218,000 tonnes, compared with the previous month's reading of 265,000 tonnes. So why has the market rallied by as much as 60¢ per pound off the mid-December lows – and right in the midst of a downdraft in the stock market?

The ICSG data are dated, and it's fairly clear that more recent indicators are not nearly as bearish. First, Chart 2 shows that the anticipated buildup in warehouse stocks is going nowhere. After a brief move to 256,000 tonnes, combined warehouse stocks at the LME, Shanghai, and COMEX have slipped back to 208,000 tonnes, just above the lows for the year.

Warehouse stock movements are not an accurate barometer of demand, and history has shown that they are not a leading indicator either. With some time lag, however, warehouse stock movements have accompanied all major moves in price. Indeed, the current warehouse activity is precisely reflective of the market's current behavior of trading right back into the middle of the range it has now held for the past two years.

Chilean production in 2007 grew at an average monthly rate of 3.8%. September was an extraordinary month that saw output jump by 21% over September 2006. There was no follow-through, though. Output in October, November, and December was down 2%, 1.5%, and 0.6% respectively.

Demand has slowed somewhat. As of the most recent ICSG report, global usage is growing by just over 7% over 2006, down from a rate of just over 8% for most of 2007. Total refined production has moved up from a growth rate of 4% at mid-year to about 5%, and hence, the narrowing deficit.

While the economy in the US has definitely slowed down and there is no question that the effects of the housing crisis will continue to spread beyond US borders, we should keep in mind that the bull market in base metals had little if anything to do with consumption growth in industrialized regions, which has been flat for years. Rather, the creation of infrastructure in China, India, and other developing nations has accounted for the torrid demand that saw copper and other base metals double and triple in price. There is no evidence that this phenomenon has stalled. Chinese imports of refined copper rose by 80% in 2007. The most recent data show that December imports jumped by

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16% over December 2006. It may be a challenge to maintain this pace, but by the same token, it has not let up yet.

There is nothing extraordinary to be garnered from a study of the open interest. Commodity funds are net-short. With the market so strong, we will get the inevitable short-covering rally as shorts throw in the towel. The size of the open interest is relatively modest compared with copper itself and other commodities. Which leads us to conclude, of course, that speculative activity is not playing the role it might be in some other markets and that the market is being guided by fundamentals.

The December 11 issue of *Focus on Futures* suggested somewhat guardedly that "...we're not uncomfortable recommending a long position with a good-anytime stop at the lows of the nearby contract." The market has moved higher since. We now suggest raising the stop to $3 per pound, basis May, close only. *[February 7, 2008]*

Chart 1 – March copper (bar), Dow Jones (line)

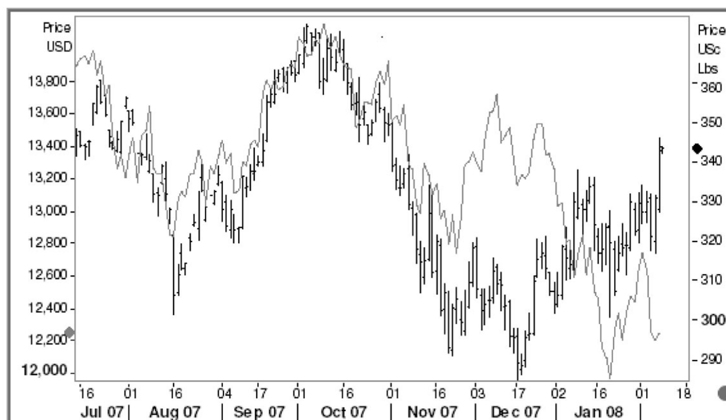

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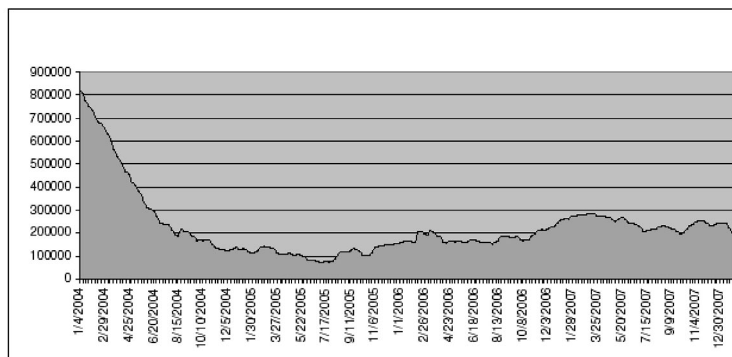
Chart 2 – Global warehouse stocks



Courtesy Reuters

COTTON

No shortage – yet

Recessionary fears dominate discussion of just about all markets, and cotton is no exception. Long regarded as an industrial commodity in which demand is expected to fall during periods of economic weakness, traders are watching for any sign of slipping consumption. And, indeed, there are several developments that bears can point to that would seem to indicate that demand is faltering.

In a report released on January 24, cotton analyst Cotlook said that consumption has softened. Rising raw material prices have squeezed profits at textile mills. With profitability waning, mill operators are more likely to become cautious buyers.

In the February supply/demand situation report the USDA confirmed Cotlook's warning by lowering its esti-

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mate for 2007-08 global consumption from the January estimate by 1.7 million bales, to 126.32 million bales.

Evidence of declining purchases by foreign mills has emerged in the form of a steady, but lighter, US export market. The USDA has been trimming its estimate of US exports for 2007-08 over the past couple of months, from an early season peak of 17.5 million bales to the current 15.7 million bales, still a 21% increase over 2006-07. Weekly commitment data show that in early December, contracted sales were 35% ahead of the previous season. With this past week's data, we've fallen back to 30% in front of last year.

The USDA report was bearish all around. The estimate for Chinese output was yanked back up to 35.50 million bales after being lowered last month. Together with the demand-side revisions, 2007-08 global ending stocks are now forecast at 57.33 million bales, or 45% of consumption, up from 42.8% last month.

While the hard data have definitely shown that consumption has fallen off to some degree, we're not convinced that an economic slowdown will have a material impact. Recent history shows that large swings in cotton prices have had a greater correlation to changes in supply than they had with demand.

Chart 3 illustrates that global cotton usage has grown in every year since the 1998-99 season, whereas production has been far more volatile. We've seen some sharp economic downturns during this period. Since consumption continued to grow, there is no evidence to prove that the bull and bear markets that cotton has put on the board were direct responses to anything other than significant crop failures or bumper crops, respectively.

For example, in 2001 cotton prices plunged to below 30¢ per pound at the same time that US GDP was dropping dramatically. But global output also jumped by about 10% that year. The economy recovered, but during the next season, cotton output plunged, which surely accounted for the major bull market that followed.

Naturally, anything can happen if the global economy slips into the kind of steep, prolonged recession last seen in the '70s. But at this time the only precedent we have is one that shows that the operative variable for this market is the level of global output.

The National Cotton Council of America released its US cotton acreage forecast on February 8, after the market close. The number came in at 9.5 million acres, near the high end the range of guesstimates of between 9.1 and 9.6 million acres. This is down from 2006-07 plantings of 10.83 million acres, which was already down from 2005-06 area of 15.27 million acres. The result was somewhat disappointing for bulls, and the market responded with a 2¢-per-pound selloff.

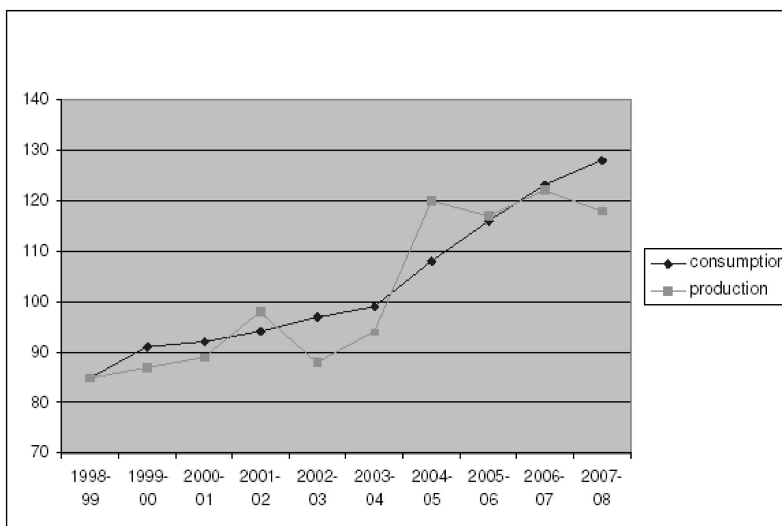
In isolation, cotton prices may seem high, but the market has no experience with grain prices that have doubled and tripled and stayed up for so long, allowing even tardy farmers ample opportunities to lock in new-crop prices at previously unheard of levels.

At present there is no shortage of cotton. That is not the issue. The US is the world's supplier of last resort, and its output is in perpetual decline, which leaves the market vulnerable to both unexpected supply problems such as weather and the possibility that demand will remain stronger than economists would have us believe.

As first notice day for March approaches, we advise rolling long positions forward to new-crop December.

[February 8, 2008]

Chart 3 – Global production and consumption



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CORN

Still playing piggyback

The February USDA supply/demand situation report was almost a carbon copy of the January report. Not that many changes were expected. At this time of year the Northern Hemisphere crops have long been harvested. Estimates for other key producers were largely unchanged, save for a downward revision for Mexico of 700,000 tonnes, to 23.2 million tonnes, but that was accompanied by a downward revision for its consumption by a similar amount. Global ending stocks were revised upwards by a smidgeon, to 13.2% of consumption, from January's 13.1%.

Over the past several months we've take the position that the corn market did not have the bullish fundamentals to carry prices to new plateaus. Rather, we argued, prices were tagging along in sympathy with the wheat and soybean markets. But of course there's more to it than mere sympathy. As wheat and soybean prices rise, acreage will swing even more sharply than already expected to beans, and to some degree, to spring wheat. But we are dealing with two completely different situations in which even the acreage case does not warrant this dramatic move.

The US has almost literally run out of wheat and beans. At least in the case of beans, we're only weeks away from the South American crops coming on line, but for wheat, the smaller-than-expected winter wheat acreage report back in January has put the wheat market at the point of no return. We've been focusing on the inter-market comparative study, but it's important to highlight our point that we cannot compare the magnitude of what's happening to the internal fundamentals of corn with the other US crops.

Without a doubt, the market's fundamentals are solidly bullish. Since March corn broke out in November, prices have shot up by over $1 per bushel, a 25% increase. That's roughly the same as the percentage increase for beans and wheat. Actually, the January USDA report did deserve a decent rally. Global ending stocks were revised to 13.1% of consumption, down from December's 14.2%, and down from 17.5% at the end of 2005-06. The 2007-08 season was the third consecutive season of production/consumption deficits. But while wheat prices have soared to absurd levels since November, corn prices have remained at about the same level they were after reacting to what was quite a bullish report.

The USDA's forecast for US exports should easily be met. As of the most recent weekly export report, commitments stand at 47.3 million tonnes, 33% in front of last year at this time, against an estimate of an increase of only 15% over 2006-07. Shipments are exactly 15% ahead of last year. Obviously there is a high degree of anxiety among foreign buyers who are booking sales well in advance of their needs. First come, first served.

Ethanol was the big story for corn, but there have been no fresh bullish developments on this front for a very long time. If anything, it's gone the other way. It is now fairly clear that estimates for the amount of corn that would be used for ethanol were optimistic. The early-season forecast for 2007-08 of 3.4 billion bushels was revised down twice and now stands at 3.2 billion bushels.

On January 28 the Congressional Budget Office released an estimate for an increase in 2008-09 to 3.94 billion bushels. However, industry analysts have maintained all along that based on actual data of consumer consumption of ethanol, these estimates are still too high, which means that the USDA will, sooner or later, revise its estimates down once more.

Although we never went so far as to recommend a short position, we've definitely been wrong about this market. Nonetheless, we are steadfast in our opinion that these prices are not sustainable. In the meantime, observe from the sidelines. *[February 8, 2008]*

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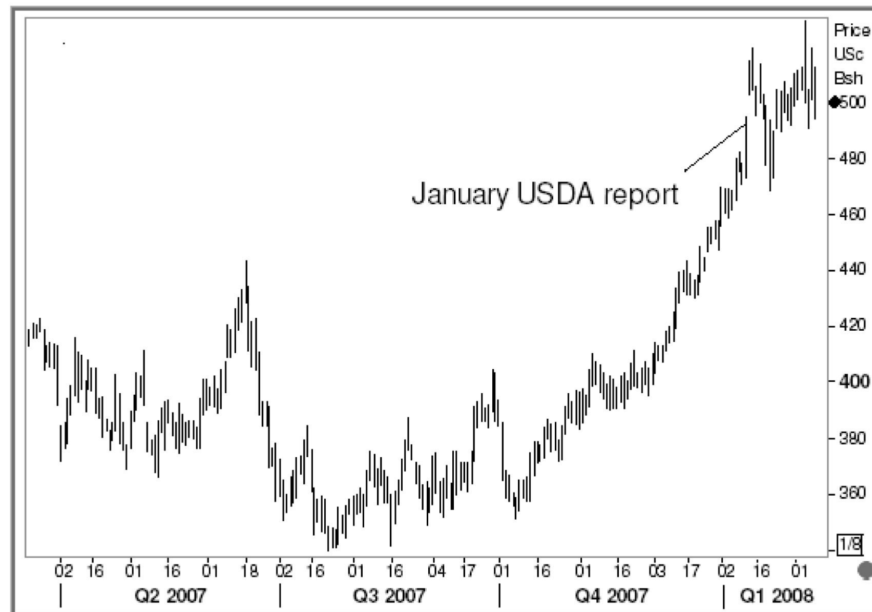
Chart 4 – March corn



Courtesy Reuters

SUGAR

Supply-demand fundamentals sweeten bullish case

Sugar prices were just breaking out of long-held resistance levels when we last discussed the sugar market on January 4 and were just about to spike to the 13¢ level (Chart 5). The initial bull run of what we believe is the beginning of a fresh bull market was somewhat suspect. A large Brazilian trading firm, Fluxo, was forced to cover short positions when ICE placed trading restrictions on the firm. It was never clear exactly what the nature of the problem was, but it does seem that the move was independent of any changes in the broader supply/demand fundamentals. Either way, it took a couple of days to sort out the crisis, and when it was over, it took only two sessions for the market to collapse back to the 11¢-per-pound level.

With this issue behind us, it's comforting for bulls that the market has since recovered and has traded almost back to the previous highs. And we're not surprised, because all developments in the market have been constructive for the bull camp.

Probably the most significant change is that the estimates for 2007-08 Indian output have been dropping steadily. When the cane harvest began in the fall, estimates for sugar output reached as high as 33 million tonnes. But lower-than-expected yields have seen estimates fall rather dramatically, and they now range between 26 million and 27.5 million tonnes. In 2006-07 Indian production was 28.4 million tonnes.

The pressure on prices that hung over the market from potential Indian exports has certainly been eliminated. Two consecutive years of bountiful crops in India was certainly one of the largest contributing factors to the sharp drop in prices, to 9¢ from 20¢ per pound. Now, even though the Indians are still going to produce much bigger crops than they did before the 2005-06 season, domestic consumption is forecast to grow to 23 million tonnes. With the Indians' penchant for maintaining ample inventories and with production and consumption levels converging, there won't be much room for exports.

The cane crop in Brazil is expected to increase by more than 10% in 2008-09. But ethanol consumption is expected to grow by about 20% for the marketing year, to close to 20 billion litres. Over 90% of new cars sold in Brazil are flex-fuel, which can run on any combination of petroleum or ethanol fuel. Crude oil prices may have come off the $100-per-barrel-mark, but are still very high. As long as ethanol prices remain competitive, then, consumption will continue to grow.

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With the harvest drawing near, crushers will be deciding on allocations for their sugar/ethanol ratio. The sharp gains in the cane crop cannot be expected to increase Brazil's exportable surplus of sugar by a significant amount. Analysts are forecasting Brazilian sugar output to increase by 2 million tonnes, to 35 million tonnes, but that hinges on the decisions Brazilian crushers will make in the coming months.

Forecasts for 10-million-tonne-plus global production/consumption surpluses for 2007-08 are shrinking. Those estimates were based on a much higher Indian crop. At present – considering all recent developments – we are probably looking at a surplus of about 5 million tonnes.

According to the USDA's *World Sugar Production Yearbook* released in December, 2007-08 global ending stocks are estimated at 29.6% of consumption. This figure does not account for a downward revision of 2007-08 Indian output. A rough calculation that includes the lower output figure would put global ending stocks at 27% of consumption – dangerously low by historical standards.

For 2008-09, the forecasts are in the neighborhood of a balanced market. We believe that is the best-case scenario.

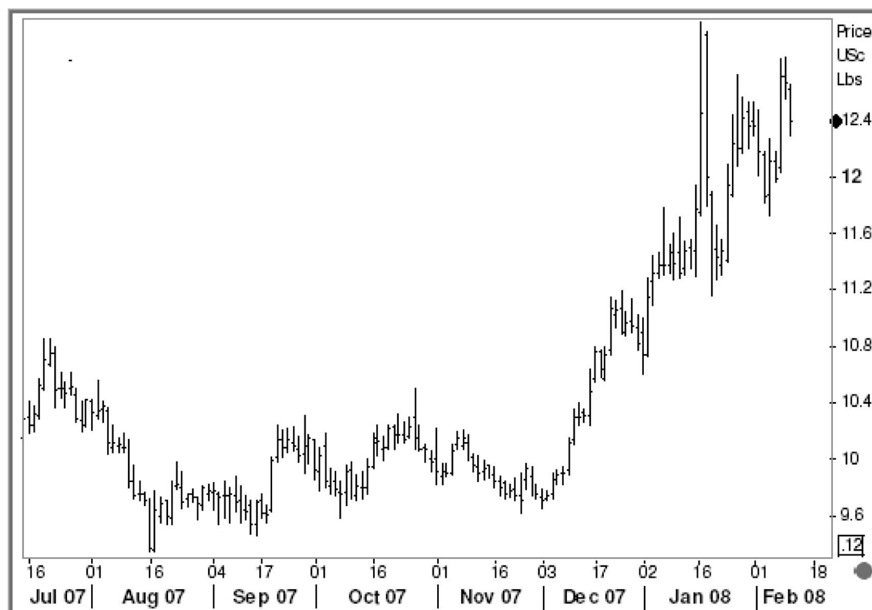
First, Indian sugar area is down about 20% from 2007-08, which has prompted crop estimates of about 25 million tonnes. If yields don't improve, the sharp rise in Indian domestic demand will mean that even the 2.5 million tonnes of exportable surplus that India contributed to world trade will not be available.

Next, the Brazilian sugar/ethanol ratio is a wild card, which will depend on the economics of producing ethanol, but will have a significant impact on Brazil's exportable surplus.

Then, a rather futuristic wild card that has been the subject of discussion in the rumor mills is the possibility of a new Administration reducing or even eliminating the 50% tariff that the US charges on ethanol imports from Brazil. Were this absurd, protectionist tax to be repealed (aside from the dramatic bearish ramifications for US corn prices), sugar prices would skyrocket. Remain long.

[February 12, 2008]

Chart 5 – March sugar



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