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# Cocoa: disappointing Ivorian crop explains *part* of the mystery

Many analysts continue to be baffled at how cocoa prices manage to hover near 30-year highs in the presence of what seem to be bearish fundamentals (Chart 1). We've been equally puzzled (see *Focus on Futures*, November 27), but as the main crop is harvested and delivered to Ivorian ports, the reason for the market's strength becomes somewhat more understandable.

The 2009-10 season was billed as a recovery year for the Ivory Coast, and when the marketing season began, it certainly seemed that the crop would be considerably larger.

The port arrival rate has fizzled, though. In early December, arrivals were running about 50% ahead of the same time in 2008-09. Consider that the most recent data show that arrivals stand at 751,000 tonnes, compared with 681,000 tonnes last year, an increase of only 10%. An even more stark reminder that Ivorian production may very well be in perpetual decline is the precipitous decline from 2007-08, when arrivals at this juncture of the season stood at 835,000 tonnes!

Output in most other cocoa producing nations has been growing as the result of ambitious programs to ramp up production.

Cameroon has seen output grow steadily and now produces about 190,000 tonnes, compared with 125,000 tonnes 10 years ago.

Brazil is not likely to reestablish its position as the world's second largest cocoa grower, but after output fell from a peak of over 300,000 tonnes to a low of about 140,000 tonnes in the 1990s, production has climbed to 170,000 tonnes.

Ghana has doubled output over the past 10 years to 700,000 tonnes. Neighboring Nigeria saw its crop jump by 25%, to 200,000 tonnes this past season.

In late December, the Indonesian agriculture minister released a headline-grabbing forecast for 2009-10 harvest of close to 1 million tonnes, up 6% from 2008-09 production. Output has recovered from the worst of the Vascular Streak Dieback disease. But the government's number is trumped up, to say the least. Private European analysts estimate the crop at 540,000 tonnes, up from 500,000 tonnes last year.

The additional supply has definitely served to fill in the gap left by smaller Ivorian crops and will carry the market for now. With a pickup in demand, however, the additional supplies from the countries listed above may be insufficient to cover a deficit left by a permanent decline in Ivorian trendline production. Indeed, analysts estimate that grindings will increase by 4% to 5% in 2009-10.

There is no evidence just yet that consumption has grown, however. Recently released fourth-quarter grind results out of North America and Europe were largely flat, as expected.

Butter ratios continue to erode (Chart 2), which means that there is no great incentive for processors to buy beans for processing other than to meet current orders.

The only apparent bullish factor is the abrupt slowdown in the pace of Ivorian arrivals. All other regions are experiencing at least modest production growth. Demand is sluggish. So what's keeping this market right near multi-decade highs when just about all other commodity markets – including energy, metals, and grains – have responded with sharp corrections to the recent rally in the US dollar?

Investment interest is certainly a factor. Chart 3 shows that open interest is fairly moderate considering the magnitude of the move and compared with where it was when prices reached these levels in mid-2008. As a percentage of

## Inside



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



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total open interest, though, the commodity fund net-long position is not that much smaller than it was in 2008.

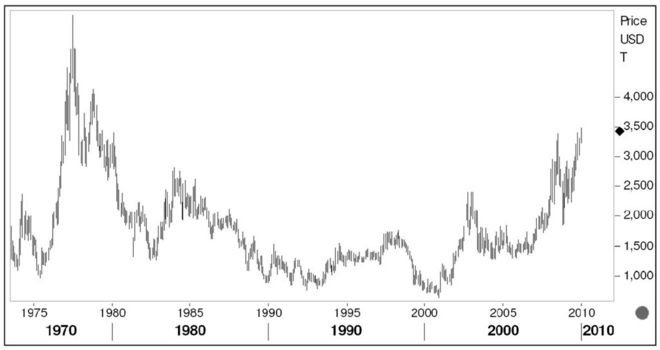
In conclusion, we've expressed concern over the years about the aging plantations in the Ivory Coast. From the production pattern that is developing it seems that those concerns were not unfounded. Although the crop will probably be considerably smaller than even the most connected analysts believed three or four months ago, decent output growth from other regions and slack consumption could make this soaring market susceptible to a setback. Corrections, however, have been short-lived and small when compared with historical standards for this market.

The global stock-to-consumption ratio is about 42%, which is about mid-range for cocoa, and the market obviously believes that we remain vulnerable to tightness.

Our recommendation to maintain long positions small enough to allow you to sit through counter-trend moves without experiencing too much anxiety has proved to be a winning strategy. Remain long.

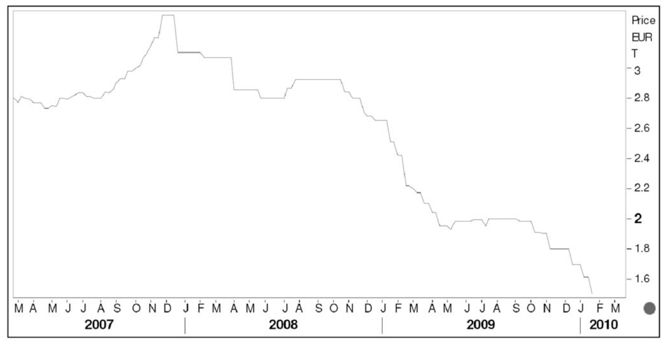
*[January 25, 2010]*

**Chart 1 – Monthly nearest contract cocoa**



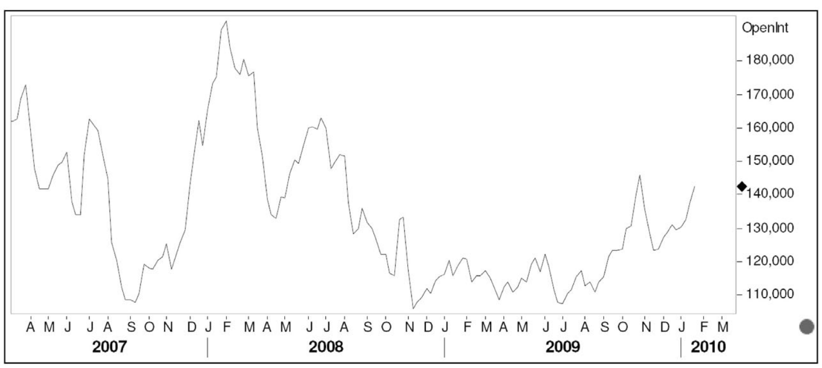

*Courtesy Reuters*

**Chart 2 – European butter ratio**




*Courtesy Reuters*

**Chart 3 – ICE cocoa open interest**




*Courtesy Reuters*

## SUGAR

# Running out?

India has certainly been the epicenter of the global sugar shortage, but it is not the only country that has experienced shortages that have necessitated larger-than-normal imports.

Neighbor Pakistan – largely self sufficient in the past – is in the second consecutive year of crop failure as well. Output in 2009-10 is estimated to fall to 3 million tonnes, down from 3.5 million tonnes in 2008-09 and 4.2 million tonnes in 2007-08. The resulting shortfall will have to be supplemented with imports to meet domestic consumption of 4.3 million tonnes. Carryover stocks are reportedly about 500,000 tonnes. Even if those inventories are drawn down, imports of 800,000 or so would be required. Like India, the government has relaxed restrictive tariffs through June 1 to clear the way for imports.

Russian farmers are looking to expand beet area to increase output by as much as 35%, to over 4 million tonnes. This ambitious project may not accomplish much to alleviate tightness, though, because processing capacity would also have to be expanded, and there seems to be some doubt whether that could be achieved. As it is, imports for 2009-10 are expected to jump by 1 million tonnes from 2008-09, to 2.4 million tonnes.

Indonesia also had a poor crop, and output estimates keep slipping. Production of 2.4 million tonnes and consumption of 4.4 million tonnes leave a 2-million-tonne shortfall. Imports are typically about 1.5 million tonnes, and will obviously need to be much higher this year. The agriculture ministry has announced that current inventories of 350,000 tonnes will be gone in just a few weeks.

Chinese demand has been growing faster than production. The 2009-10 marketing year is expected to leave a production/consumption deficit of over 2 million tonnes, compared with a deficit of 1.5 million tonnes last season and a *surplus* of 1.6 million tonnes in 2007-08. So until recently China was largely self sufficient. Just over the past couple of months, however, it has sold close to 1 million tonnes of reserves to the domestic market in attempt to insulate users from much higher priced imports. If inventories are in fact being depleted, imports can't be too far behind.

The list goes on with other importing countries, such as the US, Mexico, and Vietnam, which will see their import needs increase in 2009-10. None by staggering amounts, but collectively enough to make an impact.

There are several bearish developments. Brazil lowered the required ethanol-blend ratio in gasoline to 20%, down from 25%, primarily to quell a tight ethanol market, but also to free up some cane for sugar crushing. The edict is in effect for 90 days, starting February 1.

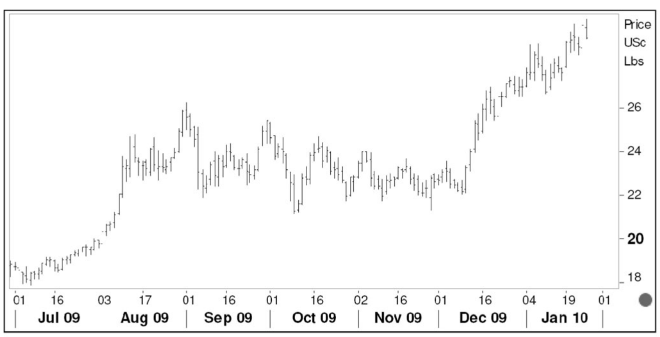
The EU has sugar available for sale but is restricted by WTO agreements to export only 1.3 million tonnes per annum. That level has reportedly been breached, and there are still close to 1 million tonnes available for export. Negotiations are underway to expand the limit because of soaring world prices, and it is reasonable to assume that the EU will be allowed to sell all or at least part of their exportable surplus.

Even with additional supplies available, we're not out of the woods. Estimates for the global sugar deficit for 2009-10 vary wildly, from 6 million to 14 million tonnes. Ending stocks as a percentage of consumption are estimated at about 30%, but we're not too sure about what that means, because there does not seem to be many countries with surpluses, and we'd be challenged to name the owners of those inventories.

Speculative activity has certainly been a factor in driving prices to multi-decade highs. The net-fund long position is larger as a percentage of total open interest than it was when open interest peaked in early-2008 (Charts 5 and 6). There is no doubting the bullish fundamentals, though.

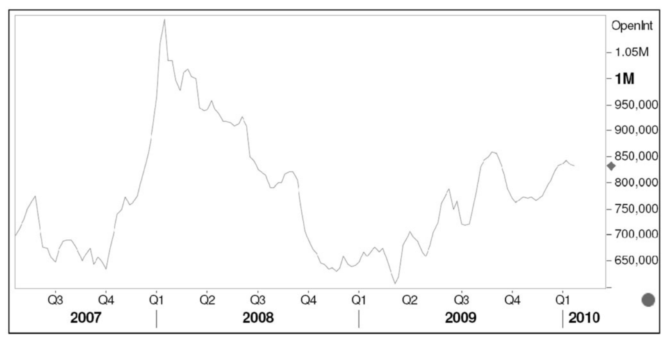
Remain long. *[January 26, 2010]*

**Chart 4 – March Sugar**




*Courtesy Reuters*

**Chart 5 – ICE sugar open interest**




*Courtesy Reuters*

**Chart 6 – ICE sugar net commodity-fund open interest**


*Courtesy Reuters*

**CORN**

# A record US corn harvest subdues the bull

In the days leading up to the release of the January USDA supply/demand situation report, corn prices were pushing up against the top of a three-month range (Chart 7). The data appeared to have altered the landscape for the foreseeable future and quashed any hopes bulls may have had for a topside breakout.

The 2009-10 US crop was revised to a record 13.151 billion bushels, up 230 million bushels from the December estimate of 12.921 billion bushels. This was totally unexpected, and it was the kind of report for which we reserve the phrase "traders were shocked," rather than the milder "...surprised." The average analyst guesstimate was 12.821 billion bushels, with the highest estimate being only 12.996 billion bushels. The 330-million-tonne miss by analysts explains why the market had rallied before the report. Even the most sophisticated and respected analysts believed that the late-planted and subsequently late-harvested crop would suffer abandonment and yield loss.

As it turns out, the crop was hearty enough to combat the adverse weather conditions that market participants were so sure would result in a sub-par harvest. The harvested-to-planted ratio was 92%, up from last year's 91.4%, but down from 92.5% in 2007-08. Yields surpassed the already-record December 162.9 bushel-per-acre estimate, to an even larger record of 165.2 bushels per acre, up sharply from the average of the two previous seasons of 152.3 bushels per acre.

The bearish impact was contained by a 150-million-bushel upwards revision to the estimate for feed usage. As a result, the estimate for ending stocks was increased by only 89 million bushels, to 1.764 billion bushels, or 13.5% of consumption, up from the December estimate of 13%, still down from 13.9% in 2008-09.

There was more bearish supply news to follow, however. The US grows about 40% of the world's corn and accounts for about 60% of world trade. Changes in other countries' crops are therefore not monitored as closely as they might be for other commodities. While that is normally the case, recent developments in number-two exporter Argentina are significant.

In the January crop report, the USDA raised its estimate for 2009-10 Argentinean output by 1 million tonnes, to 15 million tonnes (591 million bushels). Drought at the start of the planting season did not allow farmers to plant all the acres originally intended for seeding. Argentina was on its way to a second consecutive crop failure, after last year's production dropped to 12.5 million tonnes, from 2007-08 output of 22 million tonnes. However, recent weather has been excellent, and local analysts have bumped up their forecast for the crop to over 18 million tonnes (709 million bushels).

The larger-than-anticipated US crop is certainly something bulls have to grapple with, but in the grand scheme of things, not that much has changed. Global demand is forecast to rise by about 3% over 2008-09, while the increase in production is marginal. The estimate for ending stocks as a percentage of consumption will rise to 16.9% of usage, compared with the 16.5% December estimate. If we account for the 3 million tonnes of Argentinean corn, which presumably will be added in the February USDA update, the stocks-to-usage ratio will rise to 17.2%. The increase in consumption will leave a small production/consumption deficit, but large enough for ending stocks to actually be below last year's 18.8% of usage.

Looking at the situation from a historical perspective, we find that the level of global inventories has not really changed very much from the levels that brought us the mega-bull market that drove prices to over $7 per bushel in 2008 (Chart 8).

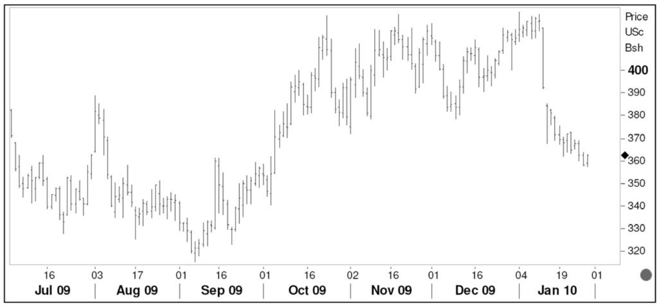
Table 1 illustrates that global ending stocks as a percentage of consumption have stabilized, but are far below the levels of the 1990s. Which is fine so long as there are no "accidents," such as crop failures or a sudden surge in demand, neither of which are risks at this time.

US exports are forecast to jump about 5% from last year, but if achieved, that would still be 10 million tonnes, or about 15%, below 2007-08 exports. Commitments are running at a rate that would be slightly above the USDA target, but not by anything that would draw attention.

We recommend liquidating long positions, for now. Weekly commitments are starting to pick up from very limp activity that we saw during the holiday period. Our interest in the long side would be rekindled if commitments begin to average over 1 million tonnes per week. Stay tuned.

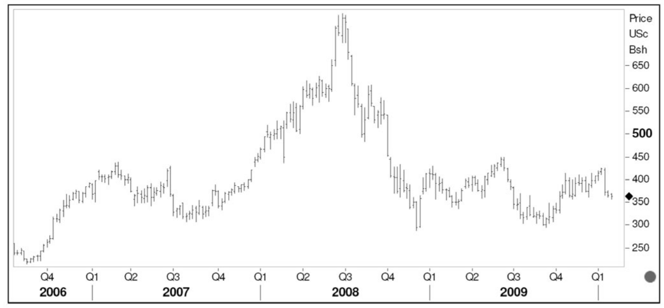
*[January 29, 2010]*

**Chart 7 – March corn**




*Courtesy Reuters*

**Chart 8 – Weekly corn**




*Courtesy Reuters*

**Table 1 – Global ending stocks as a percentage of consumption**

| | | | |
|---|---|---|---|
| **1990-91** | 29.80% | **2000-01** | 28.5% |
| **1991-92** | 28.50% | **2001-02** | 24.1% |
| **1992-93** | 31.70% | **2002-03** | 16.0% |
| **1993-94** | 25.40% | **2003-04** | 16.0% |
| **1994-95** | 28.60% | **2004-05** | 19.1% |
| **1995-96** | 24.80% | **2005-06** | 17.6% |
| **1996-97** | 29.60% | **2006-07** | 14.9% |
| **1997-98** | 29.00% | **2007-08** | 16.8% |
| **1998-99** | 32.70% | **2008-09** | 18.8% |
| **1999-00** | 31.90% | **2009-10** | 17.2% |

## COTTON

# Still tight

On the first trading session of the New Year, March cotton made a new high at just shy of 77¢ per pound. Looked pretty good, but that was it. We've since dropped back below 70¢, and it does not feel like we've found a bottom. What happened?

Even with dismal demand, cotton prices managed to rally over the past nine months – all the way from 50¢ per pound (Chart 9) – mainly because US output dropped from over 19 million bales in 2007-08 to just over 12 million bales in 2008-09 and 2009-10.

There have been several bearish developments that we are aware of. First, heading into the January supply/demand situation report, it was believed that the estimate for China's 2009-10 crop – already forecast to fall about 9% below 2008-09 output – would be chopped further. The December estimate was 31.5 million bales, and some reports out of China were saying that the crop may yield no more than 29 million bales. But the USDA actually raised the estimate by 500,000 bales. The estimate for Brazilian output was raised by 150,000 bales.

The increase was mostly offset by a combined downward revision in US and Indian output of 500,000 bales. In addition to some other minor changes, both global production and consumption were largely unchanged from last month. The market revolves around Chinese import needs, however, and an increase in supplies in China means less demand for US cotton.

Then, acreage estimates for US 2010-11 planting began to appear. The consensus is that US farmers will take advantage of what are still very high prices by historical standards and increase cotton area by about 10%. If weather cooperates, that should produce more than just a 10% increase in the harvest, because yields were well below average in 2009-10, at 774 pounds per acre, compared with 879 and 813 in 2007-08 and 2008-09, respectively. The harvested/planted ratio in 2009-10 was only 84%. The ratio is quite volatile. In the past

10 years it has ranged from 80% to 97%, so this year's result was low, even for cotton. The average during the 2000s was 89%, so even if we achieve no better than the average, the crop would actually be much larger than this year's. If we assume that yields will improve moderately, to, say, 820 pounds per acre, the crop would be close to 3 million bales above 2009-10, or up 23%.

US domestic mill consumption is still sluggish. Census Bureau data show that we are averaging about 265,000 bales per month, which is about the pace needed to meet the USDA forecast for the season. The monthly data, while still below the historical norm, is running consistently higher than during the depths of the recession.

Exports, on the other hand, have shown a marked recovery. The USDA estimate for 2009-10 US exports is 11 million bales, down 17% from last year. Commitments are running at a slightly better pace, down 13%. However, as recently as early December the US was selling cotton abroad at a rate of 33% behind 2008-09. The past three reporting periods have shown extraordinary sales that averaged 423,000 bales per week, above analysts' guesstimates and well above the average needed to reach the USDA estimate. So a recovery in demand may be closer than we think.

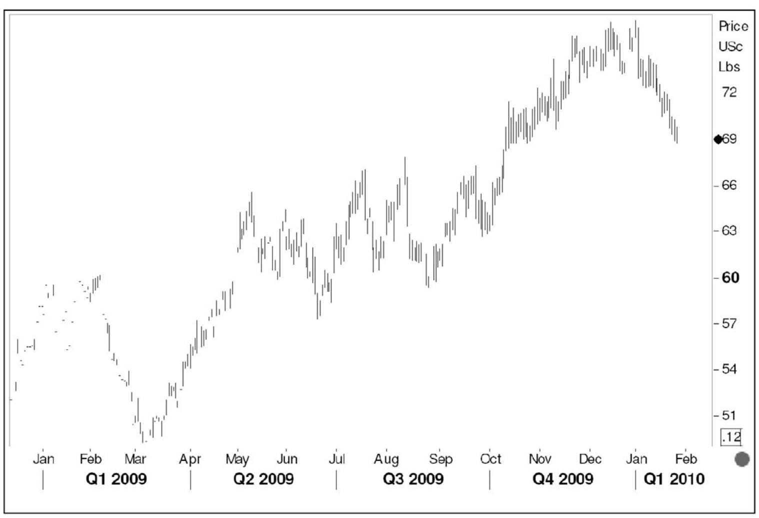
Global ending stocks as a percentage of consumption has dropped from 55% at the end of 2208-09, to an estimated 45% for 2009-10. Current projections for consumption, as illustrated, have not reflected the potential of rising demand as countries around the globe emerge from the worst of the devastating economic contraction.

We'll take the USDA's word on the improved forecast for China's 2009-10 crop, but a huge production/consumption deficit – 16.75 million bales, compared with 8.3 million bales in 2008-09 – remains. As we've seen with other commodities, such as soybeans and copper, once the Chinese government decides to open the floodgates and facilitate local industry, the buying spree can endure for some time.

The expansion in US acreage will not yield a single cotton plant until next October. In the meantime, an unexpected return to normal consumption patterns can create tightness. We view this setback as a due-course correction, and we advise maintaining long positions.

*[January 29, 2010]*

**Chart 9 – March cotton**




*Courtesy Reuters*



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Suite 250
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 Ltd.
Suite 250
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

**For U.S. Persons**
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Suite 250
181 Bay Street
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