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Ivorian cocoa crop sputters

The bull market in cocoa came unglued in early 2011 when it became apparent that the Ivory Coast was going to grow, harvest, and export a record crop despite violent political turmoil that engulfed the country. Prices plunged as bullish bets were unwound.

With record crops in the Ivory Coast, Ghana, and Cameroon, the global production/consumption surplus for 2010-11 was huge. Estimates ranged between 350,000 tonnes and 500,000 tonnes. According to the International Cocoa Organization (ICCO), 2010-11 ending stocks are estimated at 1.723 million tonnes, or 44.5% of consumption.

On the demand side, the fourth-quarter grind results showed some growth, but were a disappointment in terms of market expectations. The European grind rose by 1.8%, while the US grind grew 1.49%. So with a burdensome carryover from 2010-11 and ho-hum consumption patterns, the bears are in charge. Or so it seems.

In the early part of the season, arrivals at Ivorian ports were running consistently ahead of last year's pace. As recently as late December, port data showed arrivals ahead of last year by as much as 85,000 tonnes. At the very least, output should be a tie with last year, if not even larger.

Private forecasters started warning that the extremely dry weather would hurt crops and that the bounty would be short-lived. As we detailed in our previous discussion on cocoa (see *Focus on Futures*, December 28), deficit forecasts for 2011-12 began to emerge, but they were hard to take very seriously with arrivals so strong and sluggish growth in grindings.

It seems, however, that output has fallen behind. As of the most recent arrivals-status report released on February 6, arrivals stand at 897,000 tonnes, down from 957,000 at this time last year. Most analysts have already switched from earlier forecasts of small global surpluses for 2012-13 to estimates for a deficit of 100,000 tonnes.

One analyst estimates that Ivorian output will fall by as much as 350,000 tonnes. With no improvement in the dry weather, the midcrop could be a disaster as well. There's been some rain in early February, which could benefit the mid-crop, but it must last.

As far as demand is concerned, it is true that grinding activity in importing countries has shown only anemic growth. We believe that it is bound to pick up, though. Chart 2 shows that while the combined butter/powder ratio has fallen over the past few months, the trend remains strong. The recent selloff in bean prices to multi-year lows has made grinding even more profitable. Powder stocks have been run down to dangerously low levels, and we are therefore confident that, sooner or later, grinding activity will ignite.

Commitment of Trader figures show that speculative funds have trimmed their short positions over the past few weeks, but still hold large bearish bets (Chart 3). A short-covering rally – very soon on the way – will drive the market much higher, and that's even before the market begins to grapple with what are turning into bullish fundamentals.

We believe that many traders are entrenched in the notion that the 350,000- to 500,000-tonne 2010-11 surplus will last forever. As illustrated, at this time it seems to have been an anomaly.

Remain long, maintain stops at \$2,050 per tonne, close only. *[February 7, 2012]*

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Chart 1 – May cocoa

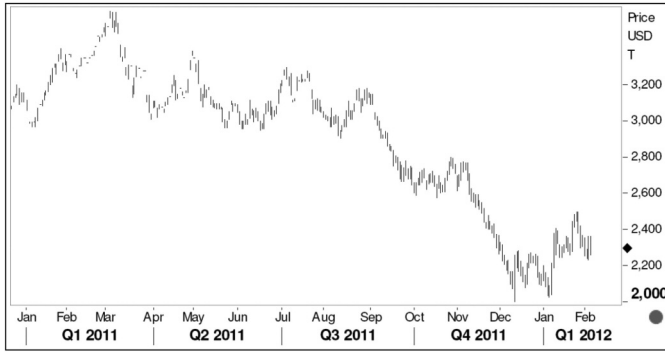
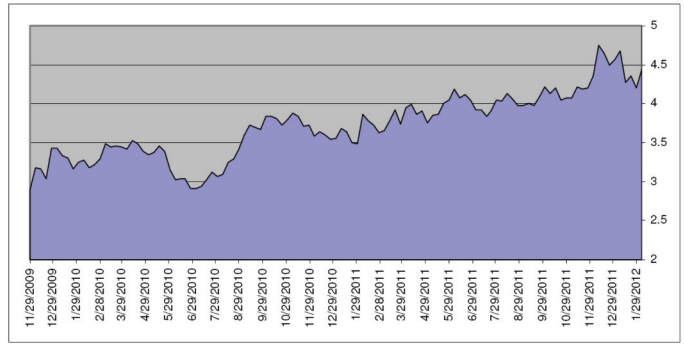
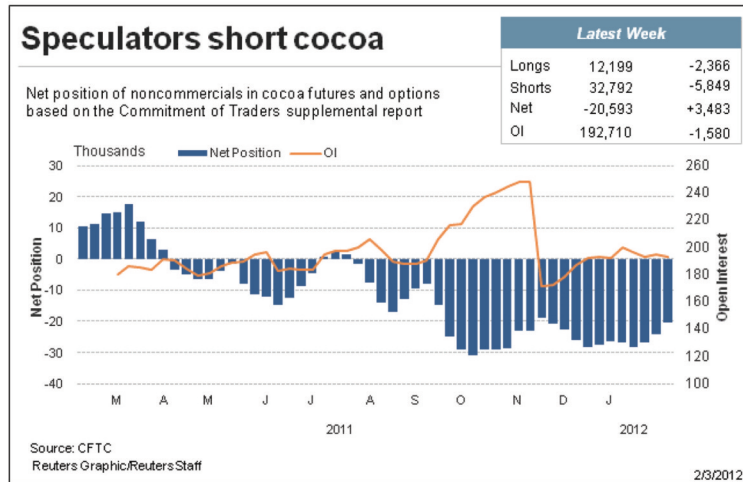


Chart 2 – Combined cocoa butter/powder



Courtesy Reuters

Chart 3 – ICE cocoa net speculators position



Courtesy Reuters

COTTON

Has the bull had it?

US cotton exports have fallen back into a trickle pattern.

In the space of three weeks back in November, weekly export commitments averaged 807,000 bales. That would normally be several months' worth of cotton purchases. It cast a whole new light on the fledgling market – or so it seemed. Chart 4 shows that the market was slow to react, with prices trading through mid-December down to a 1-year low of 85¢-per-pound. Eventually, prices rallied to just shy of the \$1-per-pound mark, only to slip back into the confines of the major downtrend line.

Since November's powerful spurt, weekly sales have averaged only 53,000 bales, but it doesn't matter very much. We've just about reached the USDA target for 2011-12 sales of 11 million bales. Rather, at this point in the season we scrutinize shipments. Last year at this point in the marketing year, US exporters had shipped 44% of the final sales target.

This year, only 38% of the final sales target has been

shipped. The marketing year runs until July 31, and exporters would have to ship just more than 250,000 bales per week to meet the USDA sales forecast. Shipments were sluggish, but have picked up over the past few weeks. Shipments averaged 288,000 bales over the past four weeks, compared with 183,000 bales in the previous four weeks.

It's safe to say that under current conditions – with commitments at the USDA target this early in the season and a fairly decent shipment pace – that the USDA has underestimated exports, and we will probably see the estimate rising to between 12 million to 12.5 million bales.

Nevertheless, the outlook for prices is not terribly bullish. The February crop report raised global ending stocks to 61 million bales, or 55% of usage. That compares with the January estimate of 53% and last year's carryover of 38% of usage. Moreover, prices are still high enough to ensure that robust planting intentions are met. With new crop December at

91.50¢ per pound, farmers can lock in prices that are still at historically high levels.

The 2011-12 crop, harvested last fall, was planted on 14.73 million acres. With severe drought not seen in many decades, farmers harvested only 66% of planted acreage. Production reached only 15.7 million bales, down from 2010-11 output of 18 million bales – which was planted on close to four million fewer acres.

The planted-to-harvested ratio for the US 2011-12 crop was an anomaly, and although moisture levels in the early going are not ideal, analysts do not expect the fiasco to be repeated in 2012-13.

Early estimates for 2012-13 US acreage have been inching up and are hovering around 13.5 million bales. Average yields over the past five years – including 2011-12 – were 815 pounds per acre. With average abandonment levels and a return to normal yields, we should see a crop of close to 21 million bales. If exports do pick up this year, as discussed above, and we add a hypothetical one million tonnes to 2011-12 sales, it does not really do much for the overall picture. Even with demand moving back to pre-recessionary levels for the upcoming marketing year, with a crop of that size we'd be looking at 2012-13 US ending stocks climbing to about six million bales, or 30% of usage, up from below 20% in 2011-12.

In conclusion, there are many variables, including US exports, US acreage, planting and growing weather, to name a few. If everything runs on course, US ending stocks of 30% of consumption will encroach on pre-bull market levels. Sell December cotton. Place initial protective buy stops at 95¢ per pound, close only. *[February 23, 2012]*

Chart 4 – December cotton



Courtesy Reuters

GRAINS

Opportunities in directionless markets

Wheat prices have traditionally commanded a premium over corn prices. Both grains can be used as a carbohydrate feed for livestock and fowl, but wheat is used primarily for human consumption. Wheat becomes animal feed only when wheat prices become competitive with corn prices. Chart 5 tracks this relationship going back to the early 1970s. Over the past few years, wheat supplies were abundant, while corn supplies were relatively scarce. Hence the wheat/corn ratio fell to zero and beyond.

The supply/demand fundamentals that led to this anomalous relationship are fading, though, and the ratio should be drawn back into its normal ranges.

As we've discussed countless times in these pages, corn-based ethanol exploded from an insignificant, boutique fuel to a significant component of the US energy market. The federal government now mandates a minimum blend of ethanol in gasoline. In the span of a decade the US moved from using an inconsequential amount of corn for ethanol production to the current situation in which about 40% of all corn grown in the US is turned into ethanol.

US farmers attempted to meet the new demand, but their efforts have often been thwarted by weather, particularly in the 2011-12 crop year. Planted corn area increased by 4 million acres over the previous season, or by 4.2%, but the weather

was so poor that yields sank precipitously, which ultimately resulted in a crop that was even smaller than 2010-11.

Argentina is the world's second-largest exporter. For awhile, we believed that a huge expansion in Argentinean corn area was going to supplement disappointing US output, but that did not pan out. Drought in South America delayed the Argentinean's expansionary plans. At one point, when the crop was first being planted, estimates ran as high as 30 million tonnes, up from 22.5 million tonnes the previous year. After assessing the damage, some analysts pegged the crop to fall below 20 million tonnes.

We'll have to wait another year to see if Argentina is capable of adding enough supplies to make an appreciable difference, but in the meantime, late rains for the late-planted portion of the crop propped up yields. Informa Economics estimates the crop at 22.5 million tonnes, no worse than the previous year.

The real bearish factor, however, is that the rate of growth in the percentage of US corn used to make ethanol is likely to have peaked just when US farmers are about to plant a monster crop. The US government has ended the era of incentives for producers (see *Focus on Futures*, February 3) by eliminating the direct subsidy to producers and the tariff on Brazilian imports. Acreage for the soon-to-be-planted 2012-13 crop will

increase by about 2 million acres over this season's area. With a return to normal yields, we could see a crop of between 13.5 and 14 billion bushels, which would be about 10% above last year's output.

Getting back to the wheat/corn ratio, while bullish corn fundamentals have plateaued, wheat fundamentals are no longer as bearish as they've been. After a major recovery from a drought-stricken 2010-11 crop year, FSU production bounced back in 2011-12, leaving the world awash with feed-grade wheat.

Northern Hemisphere winter wheat crops will definitely not be as bountiful this year. A bitterly cold winter in Europe has compromised some 2012-13 EU winter wheat crops, but,

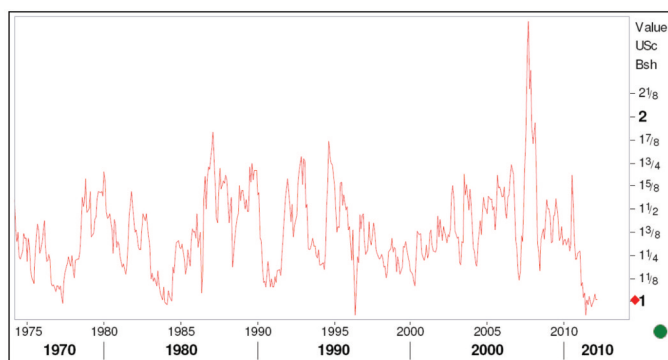
in particular, has affected Ukrainian wheat regions. Some current estimates put the Ukrainian harvest as low as 13 to 14 million tonnes, compared with 22 million tonnes last year.

In the US the winter was exceptionally warm, which hastened the maturing of winter wheat crops, leaving the plants vulnerable to early spring frost.

There is neither a strong near-term bearish case for corn nor a strong bullish case for wheat. But the era of stark extremes in both has certainly ended, as illustrated, and we expect the price ratio to reflect this.

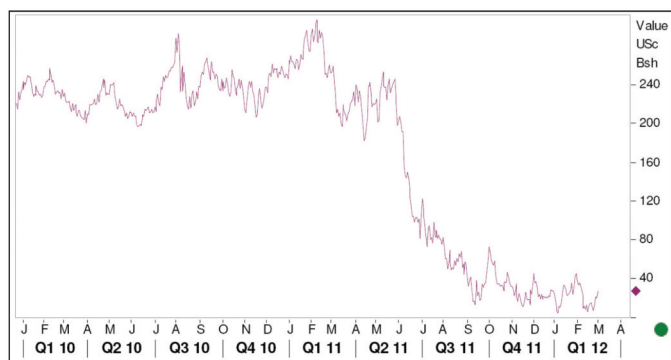
July wheat is currently trading at about 20¢ premium to July corn. Buy July wheat and sell July corn. Place initial stops at even money. [March 2, 2012]

Chart 5 – Nearest contract weekly wheat/corn ratio



Courtesy Reuters

Chart 6 – July wheat/corn spread



Courtesy Reuters

COPPER

Will Chinese copper imports reignite the bull?

Base metals have been rallying with the equity markets since this past fall (Charts 7 to Chart 12). We constructed a bullish case for copper (*Focus on Futures*, January 10) rooted in the apparent supply/demand fundamentals. An examination of developments in the copper market shows that not much has changed over the past several months.

Chinese copper imports for January fell sharply from December (Chart 13). The headlines focused on the fact that it was the first month-over-month drop since last May. Being that December was a record month for imports and November was a near-record, topping or meeting those levels would have been a hard act to follow in January. At 335,000 tonnes we were still looking at very strong imports, which were much higher than all but the last two months of 2011. In addition, and perhaps most significantly, total imports were higher year-over-year from last January.

Whatever bearish news one wants to take away from the constant barrage of data showing that the Chinese economy is growing at a slower pace than in recent years, it has not appeared in their copper-restocking activity. Shanghai warehouse stocks have been rising sharply since November (Chart

14), and that has been cited by analysts as proof that the imported metal is not finding its way to end users. Perhaps, for now. However, the drop in LME stocks has been about the same as the increase in Shanghai stocks. Chart 15 shows that the net change in global warehouse stocks has actually been falling during this period.

According to the International Copper Study Group's most recent balance sheet, the global deficit stands at 382,000 tonnes. The report is dated, as it covers the period between January and November 2011, but when plugging in more timely data, we are likely to find that the deficit continued to grow. Chinese imports have increased, as illustrated above, and production remains soft.

Chile produces roughly one third of the world's copper. Sporadic problems such as labor strife and inclement weather have restricted production growth. In addition falling ore grades at existing projects limit output potential output in December was up 2.2%, but down 7.6% in January. For the year, Chilean production was down 3.2%, which is a disappointment in terms of early-year forecasts.

There are mega-projects that are expected to come on

line in Chile over the next couple of years, and that is certainly a bearish factor down the road. In the interim, though, the spurt of Chinese imports over the past few months was a surprise to the market against a backdrop of a perceived stagnant economic environment.

The vulnerability to a correction in the US stock market became evident in early March when copper – and indeed the other base metals – tumbled when equities experienced their first meaningful pullback since last year.

CFTC data show that speculation has definitely had a large influence in this rally. The fund net-long position has been growing and is the largest it's been since August. This little selloff we're in at present has shed some open interest, but only a fraction of the runup. We could be in for some more selling. Still, we like the bullish fundamental case, so our recommendation is to raise our current stop to \$3.65 per pound from \$3.30 per pound, basis May close only.

[March 7, 2012]

Chart 7 – Copper



Chart 8 – Aluminum



Chart 9 – Nickel



Chart 10 – Zinc

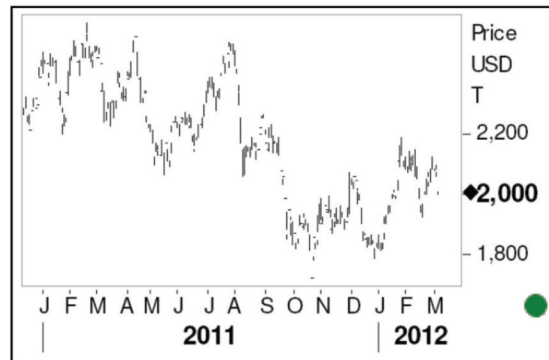
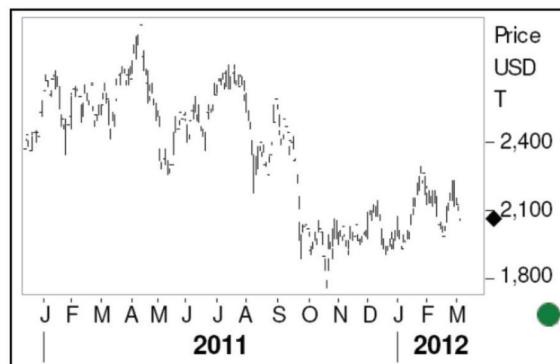


Chart 11 – Tin

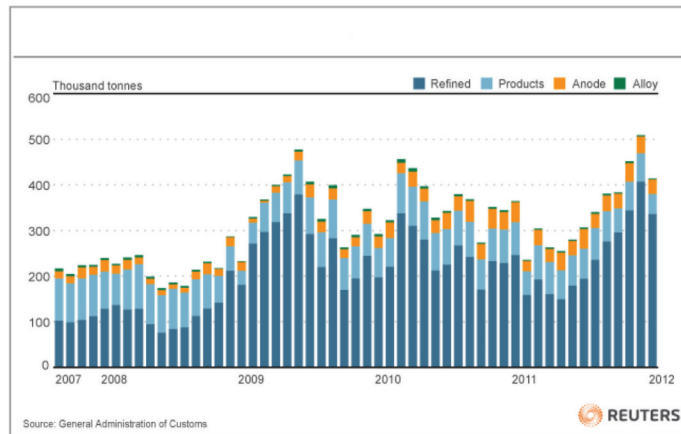


Chart 12 – Lead



Courtesy Reuters

Chart 13 – China copper imports



Courtesy Reuters

Chart 14 – Shanghai copper warehouse stocks

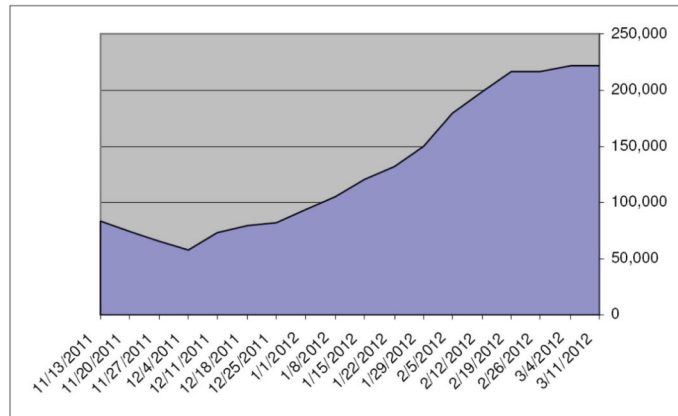
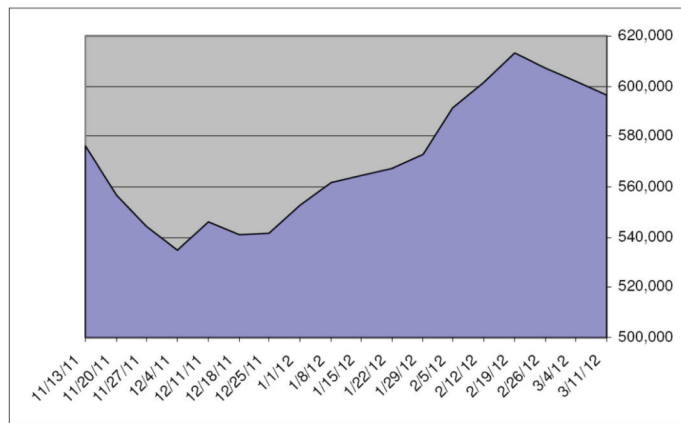


Chart 15 – Global copper warehouse stocks



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