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FOCUS ON FUTURES

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China opens the door to more cotton imports, but what about its massive inventories?

The USDA keeps “finding” more cotton inventories. Lower Chinese output constituted the only significant production or consumption revision to the 2013-14 marketing year in the December crop report. But 2012-13 ending-stock estimates were increased, putting 2013-14 ending stocks at yet another record high of 96.41 million bales, or an astounding 87.9% of consumption.

The recent rally in cotton prices has some rationale. There were several bullish developments, two of which involve China. On the supply side, early frost and snow in key growing regions lowered yields. The USDA lowered its estimate for the Chinese crop from its November estimate by 500,000 bales, to 32 million bales.

Actually, traders were surprised by the conservative downward revision. Coming into the report, the China National Cotton Reserves Corporation estimated that the damage to the crop was far more extensive, putting output at only 30.7 million bales. So it's a good bet that the January USDA report will trim its estimate further.

Then, on the demand side, the level of Chinese imports will ultimately determine the price of cotton. China is the single largest buyer of US cotton, despite the fact that its inventories are bursting at the seams. Mills import cotton because the amount of high-quality cotton in the Chinese stockpiles is limited. There were concerns that the government was planning to restrict imports to make a dent in the burdensome inventories by changing the import-tariff system. Bulls were pleasantly surprised when the government instead announced changes that would effectively maintain import incentives.

The other bullish issue – of a longer-term nature – is that rising production costs may curtail planting for the upcoming 2014-15 season. The world may very well be awash in cotton now, and it may take some time to reduce inventories, but that situation will not last forever.

When cotton sold off to 77¢ per pound in November, it touched very close to the cost of production. In the US, for example, yields vary widely from region to region, but at the national average of about 800 pounds per acre, the cost of production is about 75¢ per pound. Soybean farming –

in particular – is more profitable, and it is quite reasonable to speculate that cotton acreage will shrink even further this coming spring.

Consider that this past season, planted cotton area was 10.34 million acres, compared with 12.31 million acres in 2012-13 and 14.74 million acres in 2011-12. Our associate, John Bondurant, who is a commodity fund manager and soybean and cotton farmer, tells us that there has been divestment of cotton-intensive equipment, a clear indication that farmers are scaling back cotton farming. Farmers have been selling their cotton pickers. A new picker costs about \$650,000. With overall costs rising – as pointed out above – and with the lure of planting more profitable crops, there is little chance that farmers will be taking the risk to repurchase expensive machinery.

For the other significant producing nations, China and India, the pattern of declining crop size is not quite as stark as in the US, but certainly there is no output growth. Chinese cotton area for 2013-14 was down 6.5%. Indian production has hovered around 29 million bales since the 2011-12 season.

The market's current focus is on the prospect for a pickup in Chinese imports. The evidence continues to suggest

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that this is not happening. US exports are forecast to fall by 23% this season. Total export commitments to date are only 19% behind last year at this time, but Chinese purchases, the ones that count, are 61% behind last year. The changes to the import-tariff regime should bolster sales to China to some degree, but there is a lot of catchup to be achieved.

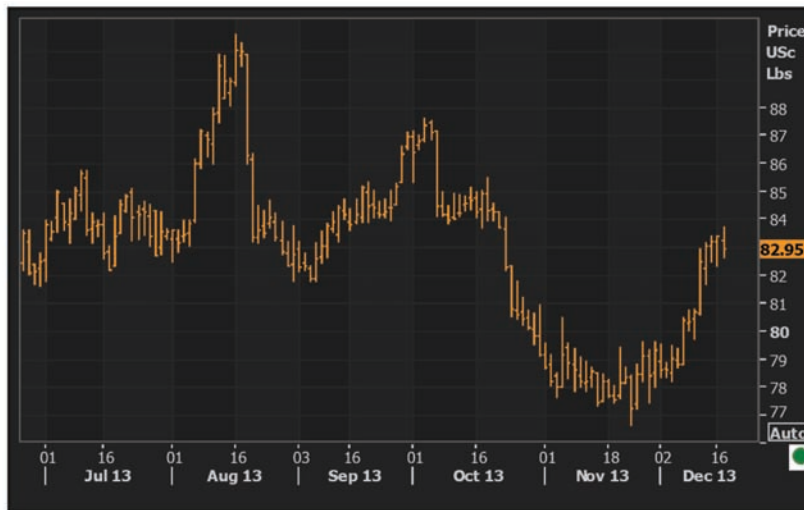
Regardless of the long-term implications of near-certain

smaller crops down the road, it is hard to imagine seeing a sustainable bull run with the massive overhang of Chinese stocks that, according to the USDA, are equal to a staggering 159% – yes, 159% – of usage.

Remain short as per our September 12 recommendation. Lower stops to 86¢-per-pound, basis March, close only.

[By Sholom Sanik, December 18, 2013]

Chart 1 – March cotton



Courtesy Bloomberg LP

NATURAL GAS

A new paradigm emerging

Since the start of November, a confluence of cold temperatures, production setbacks, and infrastructure maintenance, has conspired to push natural gas prices to the highest level since last April for a front-month contract (Chart 2). At current prices, natural gas loses competitiveness with coal-burning electricity generation, and it is unlikely that such high prices can persist for long without damaging the demand side of the ledger.

Chart 3 shows the total working natural gas in storage in the United States; the dotted line is the current data, while the solid black line is the five-year average. Due to rising production from shale development (Chart 4), it has become the norm for natural gas in storage to exceed the historical average at this time of year, which explains the market's strong reaction to the quick pace of withdrawals at the outset of the heating season.

The unseasonably cold weather did not simply increase the demand for natural gas earlier in the season than had been expected; it also curtailed production in the Permian, Eagle Ford, and Barnett shale – areas that have been at the forefront of expanding production, and that are not accustomed to

below-freezing temperatures. This came on the heels of widespread well and pipeline maintenance that temporarily reduced production in September.

The weather wildcard aside, a tectonic shift took place in the US natural gas market last month. Several large infrastructure expansions came on-stream in November, increasing pipeline as well as processing capacity in the US Northeast – the key heating demand region. Natural gas has traditionally flowed from across the country to this region; however, production growth, particularly from the Marcellus and Utica shale is rapidly outpacing demand growth.

With the expanded infrastructure alleviating bottleneck pressures, production will be able to continue to grow at a brisk pace, and more pipelines and processing plants are due to open in the second half of 2014. By 2015, production in the US Northeast should surpass year-round demand, and at that point it may become necessary to start exporting natural gas to other regions in the United States – or abroad.

This adds further support to our long-held view that technological advances that allow the extraction of natural gas from porous rock formations will continue to result in

consistent production growth, keeping natural gas prices low for the foreseeable future. Based on trading at the far end of the forward curve, it would appear that producers share this view. Chart 5 shows the forward curve of the natural gas market six months ago (higher line), as well as the forward curve as it sits presently. The distant delivery months, going out more than a decade, experienced a dramatic selloff – in some

cases nearly \$2 per mmBtus – which is likely the result of aggressive forward hedging by producers. The lower pane of Chart 5 shows the net change over the six-month period.

We recommend initiating short positions in January or February natural gas, risking to the April highs (4.825 basis January, and 4.77 basis February).

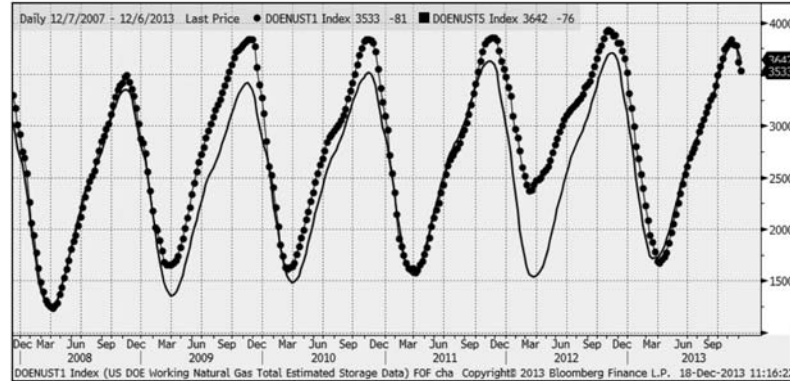
[By Jaime Macrae, December 19, 2013]

Chart 2 – Natural gas futures (rolling front-month)



Courtesy Bloomberg LP

Chart 3 – US DOE working natural gas in storage (actual vs. 5-yr average)



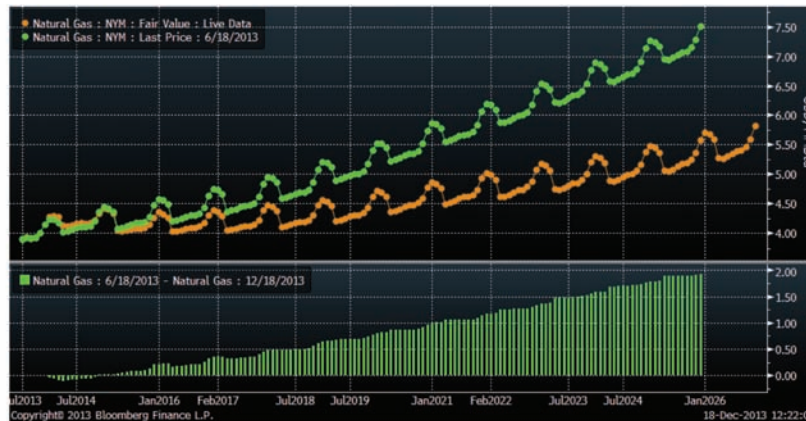
Courtesy Bloomberg LP

Chart 4 – US DOE natural gas gross production



Courtesy Bloomberg LP

Chart 5 – Nymex natural gas forward curve (actual vs. 6 months ago)



Courtesy Bloomberg LP

COCOA

West African crops surprise to the upside. Has the bull had it?

Ivorian port arrivals have been very strong. Since the main crop harvest began in October, 868,000 tonnes of cocoa beans have been delivered. That compares with just over 600,000 tonnes at this juncture of the marketing year over the past few seasons. The market has been rallying since this past summer, largely over weather concerns. But the weather has turned out to be better than expected. The challenge for the balance of the main-crop harvest, which extends through March, is the Harmattan winds, which can dry the soil, depriving crops of much-needed moisture. The winds have been mild over the past few weeks, however, and the market has responded with a sharp selloff (Chart 6).

The world's second-largest producer, neighboring Ghana, is experiencing a similar situation. Early forecasts called for a 2013-14 crop of 780,000 tonnes, down from 835,000 tonnes in 2012-13 and 880,000 tonnes in 2011-12, but results have been much better than anticipated. Arrivals stand at 486,000 tonnes, up from 347,000 tonnes last year at this time.

On the demand side, butter ratios have remained strong. The ratio spiked to 3.0 times the price of London spot beans earlier this year, after sinking to as low as 1.0 in mid-2012. The ratio is still holding well, at about 2.5. Powder prices have perked up off their lows, but remain weak and continue to be a drag on the combined butter/powder ratio (Chart 7).

In early December, the International Cocoa Organization (ICCO) revised its estimate for the 2012-13 global balance sheet to show a deficit of 160,000 tonnes, up from its previous forecast for a deficit of 52,000 tonnes, adding fuel to the

rally. It also has been predicting that we are looking at deficits for the next several years.

With the improvement in West African output, however, it is doubtful that the ICCO will maintain its gloomy outlook. While demand remains strong in both the traditional markets and the budding markets in developing countries, the key driver of the most recent leg of the rally was the uncertainty over production in the Ivory Coast and Ghana.

Commodity funds have been long this market for quite some time (Chart 8), but after spiking to new highs in November, the market has stagnated. Anticipation of bearish revisions to the balance sheet could spark a broad liquidation – which may have already begun.

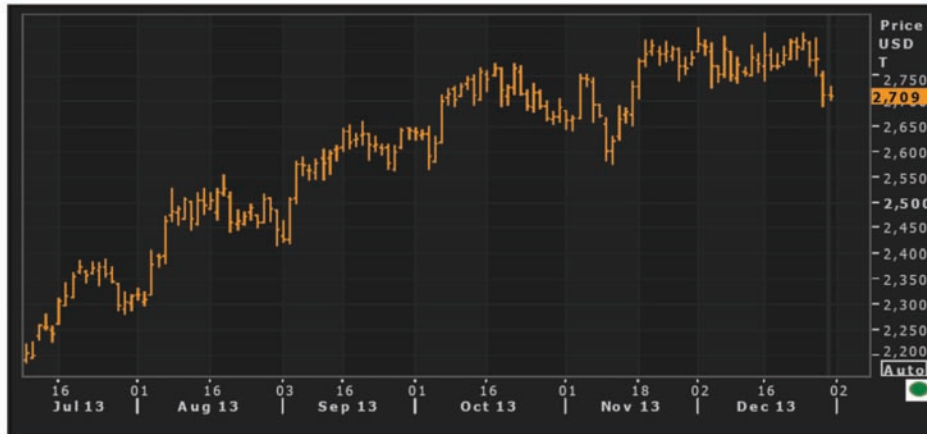
To be sure, the success of the 2013-14 West African crops is not a given. There are still three months remaining in the main-crop season, which is followed by the April-through-September mid-crop season. At present, weather conditions look favorable, but that could turn on a dime.

In January we will get a look at fourth-quarter grinding statistics for the major processing centers in Europe and North America. For the market to maintain its overall bullish posture, these numbers will have to be as good as, or better than, expected. Without a strong demand side, the unexpected positive developments on the supply side would overwhelm the market.

We missed buying the summer lows and have been recommending establishing long positions on pullbacks. If you managed to do so, we advise liquidating long positions.

[By Sholom Sanik, December 31, 2013]

Chart 6 – March cocoa



Courtesy Bloomberg LP

Chart 7 – Combined butter/powder ratio

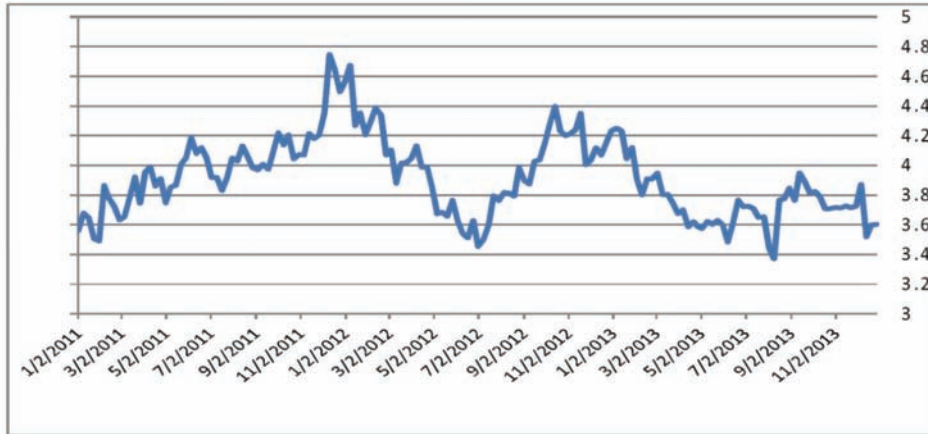
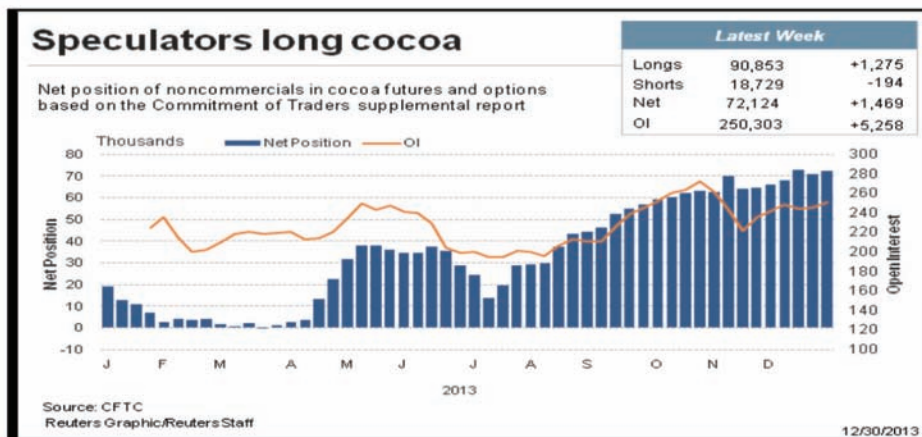


Chart 8 – Net speculator long position



Courtesy Reuters

GOLD

Is the correction over?

Could the correction be over? After over a decade of perpetual strength, gold suffered its worst losses since the early 1980s, sliding 28% in 2013. Many investors have become weary of the volatile decline, and have eschewed the metal in favor of stronger markets; however, this has helped to return this long-term bull market to health, and may have set the stage for the next major rally.

There are a few hallmarks of a bull market that has grown long in the tooth, most notably excessive speculation, radical predictions and forecasts, and a surge in volatility. These factors were all in place in 2011 when gold peaked at just over \$1,900 an ounce.

The decade-long march higher had helped fuel the rise of physically-backed precious metal ETFs, which at their peak held a combined 2,600 metric tons of gold. High profile money managers like John Paulson and Eric Sprott had launched “gold funds,” which invested principally in the metal. There was a never-ending supply of market pundits ready to espouse \$5,000 gold, and the ensuing commercial breaks were replete with messages from eager buyers for your “used and broken gold.”

When the bubble finally burst, traders were caught as deer in headlights, facing \$100 intra-day swings, and implied volatility for gold options more than doubled from a complacent 15% to over 30% in a flash. And while it was a textbook case of a bull market in need of a correction, it has taken over two years for the exuberance to wane.

Jump to today. Gold has fallen 38.55% from its high, landing it in the so-called “Box” for Fibonacci retracements – a commonly followed technical indicator (Chart 9). Mom and Pop investors, along with the stars of finance (Soros, Loeb, *et al*), have abandoned their gold ETF positions, helping to shed a third of all known gold ETF holdings (Chart 10). Even John Paulson, one of the world’s most renowned gold bulls and the manager of a huge gold fund, said he wouldn’t invest more

money in gold personally, because it is unclear when inflation will accelerate.

Alas, many investors, facing a dearth of catalysts to spark a new gold rally, have shifted away from gold – evidenced by a steady decline in non-commercial (large speculators) long positions in Comex gold futures (Chart 11). A widely-watched survey of traders shows only a third of respondents remain bullish, and the calls for \$5,000 gold have been drowned out by more bearish talking heads expecting a drop to \$1,000.

While the pendulum of investor sentiment seems to have swung to the bearish camp, the market itself is getting tighter. Those same non-commercial traders are now net long a mere 32,000 contracts, down from over 250,000 when gold was at its highs. And as 2013 waned, they added substantially to short positions, increasing the probability of a short-covering rally (Chart 12). Inventories of good-for-delivery gold at the Comex fell sharply in 2013 (Chart 13), and calendar spreads tell a tale of tightening physical conditions (Chart 14).

The steadily tightening spreads, as well as the sharp drop in registered inventories at Comex are symptomatic of a commodity market where physical supplies are being drained from the financial marketplace. Anecdotally, most of this gold is said to have been sent to Asia to meet growing demand in China and elsewhere. As supplies tighten due to growing demand for delivery in physical gold, the market gets closer to a shortage of deliverable gold – the type of scenario that typically accompanies a bull market.

From a contrarian point of view, gold is now poised for a substantial rally. A move above \$1,285 is required to confirm a breakout from the downtrend, and a further rally above \$1,430 will indicate a significant reversal (Chart 15). Prepare to be a buyer of gold should it confirm a change in trend, and those wishing to fish for a bottom should place protective stops below recent lows of \$1,180.

[By Jaime Macrae, January 7, 2014]

Chart 9 – Long-term gold Fibonacci study



Courtesy Bloomberg LP

Chart 10 – Total known ETF holdings of gold



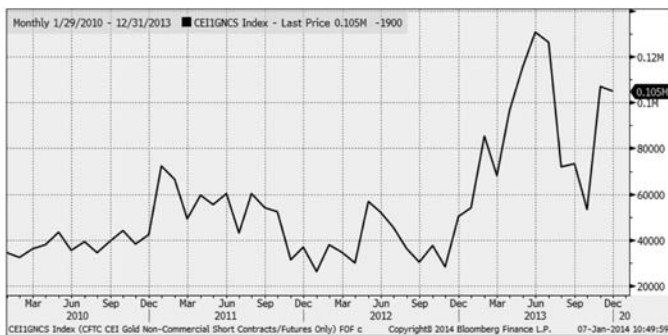
Courtesy Bloomberg LP

Chart 11 – CFTC commitment of traders non-commercial long positions



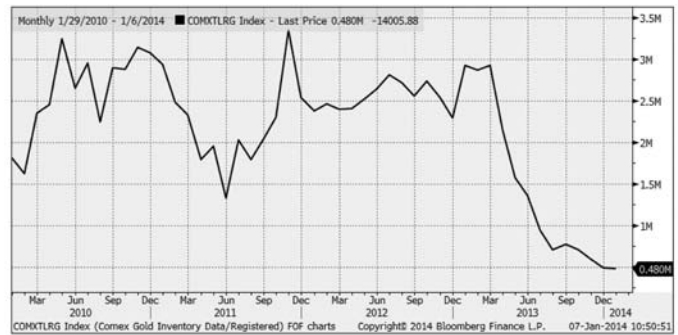
Courtesy Bloomberg LP

Chart 12 – CFTC commitment of traders non-commercial short positions



Courtesy Bloomberg LP

Chart 13 – Comex registered gold inventory (troy ounces)



Courtesy Bloomberg LP

Chart 14 – One-year calendar spread (Dec 13 to Dec 14) through 2013



Courtesy Bloomberg LP

Chart 15 – Front-month gold (weekly)



Courtesy Bloomberg LP

COPPER

Chinese copper imports go it alone

Chinese copper imports for November were slightly higher than the previous month, but were up 31% year-over-year (Chart 16). That news sparked a rally to levels not seen since this past May. In the days following the release of that data, most of the economic news out of China was on the soft side, capping the rally. Economists estimate that there will be a small decline in fourth-quarter GDP, with modest

declines in factory output and slower growth in the investment and retail sectors.

The market was making the assumption that strong imports and declining inventories meant that copper and other industrial materials were being consumed by Chinese industry. Talk of weakening economic conditions therefore cast some doubt on the longevity of the Chinese buying spree.

A look at overall global fundamentals should provide further concern for bulls that the market's strength hinges almost solely on China's importing and might not be sustainable without it. According to the International Copper Study Group's (ICSG) most recent report, through the end of the third quarter, Chinese implied demand was up 5.8% year-over-year, but global demand was up only 2.8%. Take away Chinese consumption, and global demand grew by only 0.6%.

Even if Chinese demand remained constant, there is another issue to contend with. Supply has been growing at a faster clip. Unlike the demand side, where the increase is concentrated in China, production growth has been widespread. Global mine output for the period was up 8.7%, year-over-year, with notable gains in the US, Indonesia, African producing nations, and of course Chile.

The Chilean government keeps revising up its output estimate for 2013. The most recent forecast calls for an increase of 5.7% over 2012, but year-to-date monthly data indicate that output is growing at an even faster rate of 6.5%.

In the meantime, the buildup in global warehouse stocks that we've seen over the past year has been all but wiped out

(Chart 17). Inventories have fallen in all three exchange warehouse systems – the LME, COMEX, and Shanghai. The last time warehouse stocks were this low, copper was trading near \$4 near per pound.

ICSG estimates that the global balance sheet was in a 210,000-tonne deficit through the end of the third quarter, but it expects that by the end of the year, the market will be in a surplus position of 387,000 tonnes. Although it expects demand to grow by 4.5% this year, production is expected to continue to expand at a much higher pace, putting the market in a surplus position of 632,000 tonnes.

Prices spiked to over \$3.40 per pound in December, but couldn't seem to hold, even with help from supportive US economic data and equity markets hovering near record highs (Chart 18).

Chinese imports can continue to support the rally. Nevertheless, bulls should realize that it is a fragile situation. A single headline showing a poor monthly import figure out of China can send the market into a tailspin. We advise accepting profits on our November 11 buy recommendation.

[By Sholom Sanik, January 10, 2014]

Chart 16 – Monthly Chinese copper imports

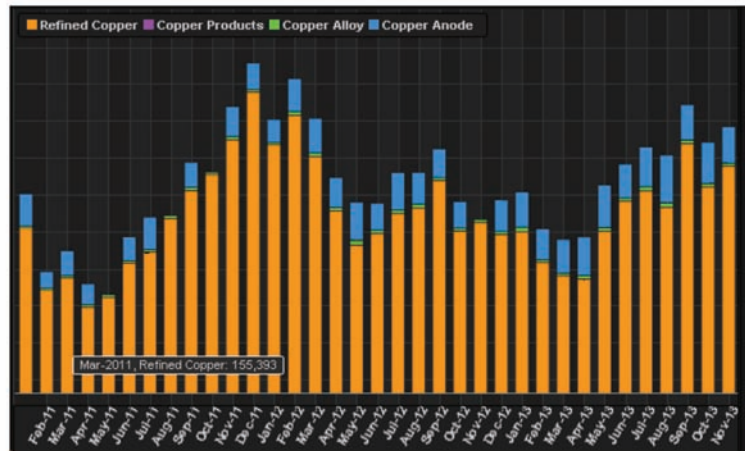
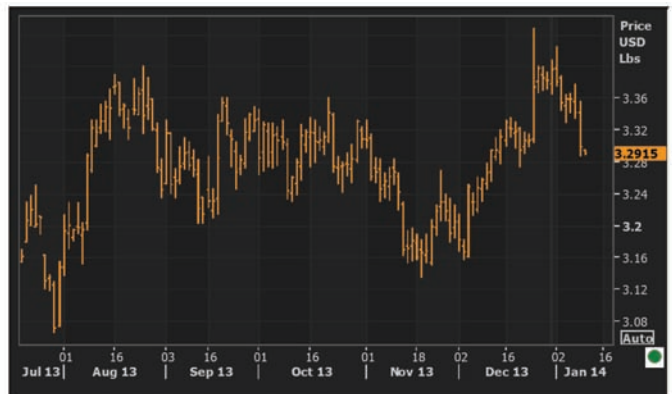


Chart 17 – Combined global exchange warehouse stocks



Chart 18 – March copper



Courtesy Bloomberg LP

CORN**Is the market still in the grips of the bear?**

The revisions found in the January 10 USDA reports for corn may have altered the bearish landscape for this market.

First, the estimate for quarterly stocks came in 364 million bushels below the average guesstimate. In itself, this was not the biggest headache for bears, because the figure has been notoriously volatile, with the USDA first “finding” and then “losing” – or vice versa – a couple of hundred million bushels here or there.

While the quarterly stocks report was more damaging to the ending stock figure, the final estimate for the harvested US 2013-14 crop was probably a greater disappointment for bears. The street was confident that yields picked up in the late going, but were off the mark by a wide margin. The average guesstimate for the bushel-per-acre (bpa) yield was 161.2 bpa, above the 160.4-bpa December estimate, but the actual figure was 158.8 bpa, below the low end of the range of analysts' guesstimates. The estimate for harvested acres was revised upwards from the December estimate by 436 million acres, to 87.668 million acres, and was above the guesstimate. That, however, was not enough to mitigate the lower yields. The final crop estimate was 13.925 billion bushels, down from the 13.989-billion-bushel December estimate, and below the average of analysts' guesstimates for 14.066 billion bushels.

The demand side was bullish as well. Despite the fear that the US ethanol market will shrink without the crutch of government subsidies, the estimate for ethanol usage in the new marketing year was revised upwards by the bushel-equivalent of 50 million bushels, to five billion bushels, just below the record set in the 2010-11 marketing year. The feed estimate was revised up by 100 million bushels, to 5.3 billion bushels.

Ending stocks will fall to 1.631 billion bushels, or 12.4% of consumption, down from last month's 13.7%.

On the international front, the only material revision was a 2.8% increase in the estimate for Chinese production. Still, with lower stocks in the US and some minor bullish revisions for other countries, the estimate for global ending stocks fell to 17.05% of consumption, down from

the December estimate of 17.34%. Traders greeted the reports with a 20¢-per-bushel rally, erasing a couple weeks of losses (Chart 19).

Although prices have been in a precipitous downtrend, we shied away from the short side in our December 8 article on corn (see *Focus on Futures*, December 8) for two reasons. One was the likelihood that farmers will make a significant acreage shift to soybeans because of better returns. The other rationale was a strong export market. Both factors are still operative.

New-crop (2014-15) corn prices have since gained on bean prices (Charts 20 and 21), but bean planting would still be more profitable when compared with the historical norm.

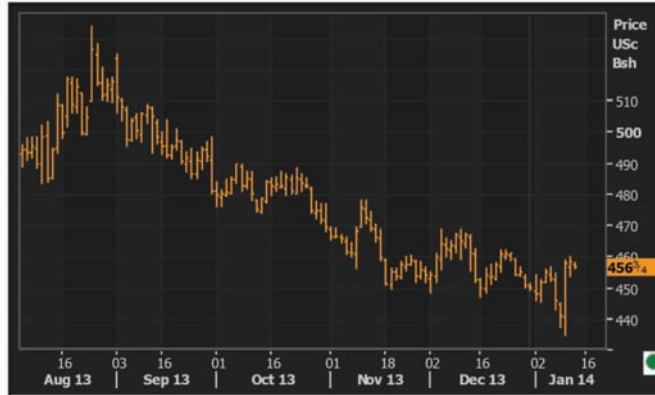
While US export commitments are still more than double last year's level, traders believe that we could see the torrid pace of sales begin to fade. China keeps turning away US corn because shipments were found to contain GMO corn that has not been approved for use by the Chinese government. We maintain that it is not quite the issue that the headlines seem to make of it. Total Chinese corn imports from all sources – which includes the US and other producing nations – amounts to roughly 5% of world trade. It is not as significant as it would be for other commodities, such as soybeans, for example, where Chinese imports comprise between 60% and 70% of world trade. Still, US corn exports have been almost nonexistent for the past two weekly reporting periods, so it is a matter that bears scrutiny.

The US remains the world's supplier of last resort for corn. The picture presented by the 2013-14 balance sheet is not quite the bountiful result that the market was expecting. Hardly a disaster, but definitely a disappointment. It is still too early to determine if enough acreage will move to other crops. To avoid a return to dangerously low stocks, new crop prices will have to move higher to encourage a more balanced approach when farmers choose between corn and beans come spring.

Establish long positions in new-crop December corn. Place initial stops at \$4.25 per bushel, close only.

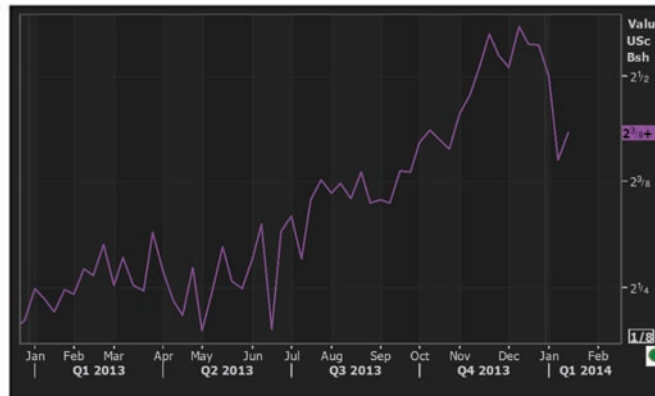
[By Sholom Sanik, January 14, 2014]

Chart 19 – December corn



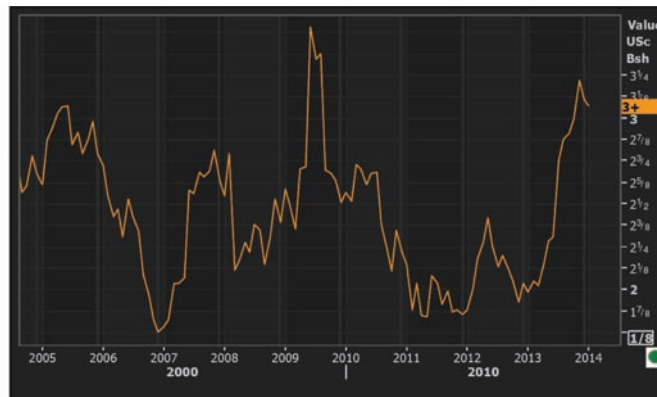
Courtesy Bloomberg LP

Chart 20 – November soybeans/December corn ratio



Courtesy Bloomberg LP

Chart 21 – Monthly soybean/corn ratio



Courtesy Bloomberg LP

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