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The commodity that cried wold

Wheat prices have approached the $3-per-bushel level frequently during the past year or so. They have also fallen each time they have done so – in most cases to fresh contract lows (Chart 1). Prices have broken upwards, yet again. Even analysts who acknowledge the existence of bullish fundamentals do not expect a sustained rally. After all, the global supply/demand balance has been tightening for three years now, and prices have done little. Why should this rally be any different?

This particular rally began on the last trading day of 2000. Trading conditions were thin, as participants began to celebrate New Year's a bit early. Shortly before the close of the abbreviated session, March wheat exploded to the upside, finishing with a gain of 7 3/4¢ per bushel, the largest single-day gain in months. There were no known, fresh fundamental developments to account for the move. The wire services offered up their typical responses in the absence of any hard news: "fund buying" and "stops were triggered." One would have expected the rally to fade shortly after traders got back from holidays. Interestingly, though, two weeks have passed, and the market has not only held the rally but has actually built on it.

Skeptics are not without cause. Although US exports have been rather dull lately, the USDA has persisted with optimistic forecasts in its monthly reports. In this past Friday's January supply/demand situation report the USDA maintained its estimate for annual exports at 1.125 billion bushels. This would represent a 3.2% increase over last year's exports. The USDA makes this forecast despite the fact that shipments are running 2.9% behind last year's pace. Export commitments are 3.2% slower than last year at this juncture of the season. If the recent trend is any indicator, the situation is not improving. Commitments for the last three weekly reporting periods were below 400,000 tonnes, far short of the kind of numbers that would be required to meet the USDA's projections for the year. Commitments thus far stand at 62% of the USDA's final estimate for the season, a sharp contrast to the average from 1985 through last season of 75%. US farmers will have to sell a lot of wheat from now until June 1 to vindicate the USDA.

The lethargic export business cannot be blamed on a slow holiday season. Average weekly export commitments this past December were 443,000 tonnes compared with December 1999 when the weekly average totaled 590,000 tonnes.

One of the bulls' favorite excuses for this market remaining so weak in the face what seemed to be such bullish fundamentals was the strength of the US dollar. "The pent-up demand would emerge as soon as purchasing power was restored," went the argument. With the dollar having plummeted by 8.5% these past few months, the bears can and do ask: "Where is the pent-up demand?"

The most likely explanation is that the USDA will adjust its annual export tally eventually to reflect the current pace of sales. It hasn't done so yet, because it also incorporates historical trendlines into its calculations. On the other hand the analysts at the USDA may know something we don't. A possible scenario is that the USDA is betting that once China's participation in WTO gets going, the Chinese will easily compensate for the lackluster sales we've seen this season.

As has been the case throughout the building of this base in prices, the supply-side issues continue to favor the upside. This trend continued with Friday's USDA report. At 41.3 million acres, US farmers will have planted the smallest winter

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

wheat crop since 1971. This compares with last year's 43.3 million acres. The street expected a low number, but it certainly was a surprise, because it came in below the low end of analysts' estimates of 41.5 million acres.

Australia, which meets some of the import needs of Asian importers, suffered a serious setback this season, producing only 19.5 million tonnes compared with 25 million tonnes last year. While this has been known for some time – the USDA did not change December's figure – not much mention is made of the fact that a very wet harvest season turned a significant amount of the crop into feed grade from what normally would have been milling grade wheat, which will eventually bring customers of higher quality wheat to the US.

Another little surprise contained in the report was the quarterly stocks total. While corn and soybeans came in higher than expected, wheat defied what might have been expected, given the slow export season we've seen. All wheat stocks stood at 1.801 billion bushels on December 1 compared with the average trade guesstimate of 1.818 billion bushels and 1.883 billion bushels in 1999.

In conclusion, the pathetic pace of US exports is undeniably an issue important enough to cause doubt as to whether this market can really go anywhere. But with a third year of shrinking global production under our belts and another one likely, this market is at the very least in a vulnerable position. If US exports do pick up, the ensuing shortages will catch the market sleeping. Then, look out! *[January 16, 2001]*

STRATEGY: *Remain sidelined but watch the export market and stay tuned.*

Chart 1 – Spot Wheat

Chart courtesy of *Reuters*

COTTON

Sliding, but uptrend still intact

Cotton prices took a nasty fall these past few weeks. Throughout the summer and up until early December, the market was trading off the prospects of a much-smaller-than-anticipated US crop. Early estimates of 2000-01 crop – based on planted acreage and trendline yields – were very optimistic. Analysts were talking about a crop that might top 20 million bales, which would have represented a major recovery from the 1999-00 crop of only 16.97 million bales. Inclement weather during both the growing and harvest periods, however, limited the crop to a very modest 17.22 million bales – hardly a recovery. Disappointing crops in other major exporting countries exacerbated the problem, and the market was well on its way to a supply-side-inspired bull phase.

Ultimately, though, a lasting bull market needs cooperation from the demand side as well. Inasmuch as traders focused their attentions on the US supply side to push prices to a level not seen in almost two years, they homed in on the US demand side to reverse the rally. Despite the disappointing crop, US millers seem confident that ample supplies will be available. With economists forecasting a slowdown in economic activity, cotton is high on the list of industrial commodities that are allegedly very sensitive to economic activity. Headlines proclaiming the possibility of recession embolden millers to continue to work with just-in-time inventory systems. This trend was confirmed in the USDA's January supply/demand situation report. Domestic usage was lowered again to 9.8 million bales, which is 400,000 bales lower than estimates in early fall.

Exports have not been helpful either. The forecast for US exports has now fallen by almost 1 million bales from the

USDA's most optimistic estimate this season to 7.3 million bales. The way exports have been going lately, it is going to be a challenge even to meet the revised forecast. This past week's export tally – at 152,000 bales – was rather robust, but it was the best export number in a month.

The average weekly commitment for the past 8 weeks was 106,000 bales compared with an average of 142,000 bales in the comparable period in the 1999-00 season. Commitments so far this season stand at 4.6 million bales and are 10.5% below commitments at this point last season. In the past 15 years, commitments at this juncture of the season averaged 84% of the USDA's estimate for annual exports, in sharp contrast to this year's 63%.

Recent developments at the global level have been negative for prices as well. Most notably, Chinese production has been revised upwards by 2 million bales to 20 million bales. When China's State Statistical Bureau first reported this revision on December 29, the selloff that began in early December picked up steam, with the market shedding an additional 4¢ per pound in the following few sessions. The net effect on the world supply/demand balance was rather dramatic.

The downwards revisions to the US and Pakistani crops paled in comparison with the improved Chinese prospects. Ending stocks are now forecast to increase over last month's estimate by 1.7 million bales to 37.39 million bales.

Only a couple of months ago we were looking at carryover stocks that were below 38% of consumption and inching closer to the levels that sparked a major bull market in cotton prices in 1995. With this month's figure we are back into a burdensome inventory territory of over 40% of consumption.

Despite all these gloomy bearish statistics, we have some affinity for the long side of this market. For starters, the jump in Chinese production is not carved in stone. Cotton merchant and analyst William Dunavant of Dunavant Enterprises has some reservations about the 20-million-bale estimate, commenting in a recent speech that "it seems they are trying to keep the domestic price low to benefit the Chinese textile industry."

The large shift in world ending stocks consists entirely of the Chinese revision. Without it, ending stocks would actually have been lower. We will get a feel about how accurate the Chinese story is from observing its importing patterns. Dunavant says that the Chinese will increase their purchases from 500,000 bales this past season to 2 million bales in 2001-02.

The Cotlook "A" Index, which is an index of prices of internationally traded cotton, was trading at a discount to US cotton prices up until a short while ago. During the recent plunge in US prices, this index continued to rise, indicating that the anecdotal evidence of healthy overseas demand was credible. Overseas consumption was actually stronger than we could ascertain from the slow pace of US exports. The index now stands at about 64¢ per pound, a premium of over 4¢ per pound. The ramification of this massive reversal from discount to premium is that US cotton is now much cheaper. It can't be long before the export market begins to pick up steam.

Commitment of Trader data indicate that funds and small speculators adopted a large short position on this slide in prices, which probably exaggerated the move. While the apparent fundamentals – according to the recent USDA data – certainly are in the bear camp, we believe that the major trend in this market is still up. The key is US exports. If we start seeing a string of weekly exports above 150,000 bales, this market will climb back towards it highs. *[January 18, 2001]*

STRATEGY: *Stay tuned.*

Chart 2 – Spot Cotton

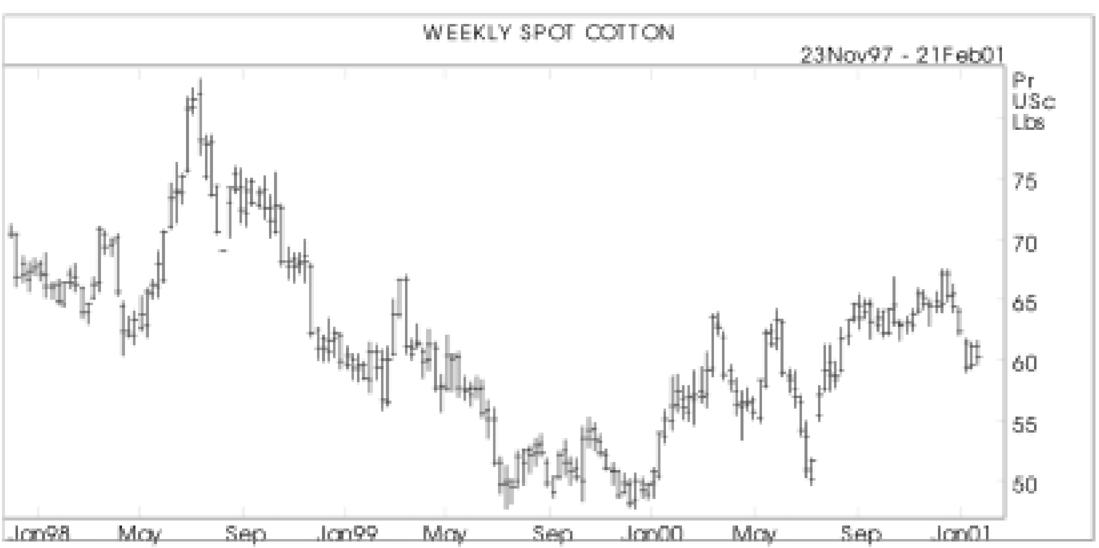

Chart courtesy of *Reuters*

COCOA

The transition is complete

In a series of articles about cocoa (July, August, and December) we discussed how cocoa was shifting from bear to bull. We referred to E.D.&F. Man's recent supply and demand estimates. The reports contained two key items: a 2000-01 Ivorian crop of 1.2 million tonnes (1.05 million tonnes of main crop and 150,000 tonnes of mid-crop) that would be 14% smaller than the previous season's, and an upwards revision of 1999-00 grindings to a growth rate of 7.9%. A global deficit in excess of 100,000 tonnes for the new crop year was all but certain. The supply/demand fundamentals of this market were actually turning bullish.

It took a bit of time for this to sink in. After all, observers had firmly believed that carryover stocks that amounted to 40% of consumption would be an insurmountable obstacle. For a while – before the rally began in earnest – it seemed that the market was going to absorb the smaller Ivorian crop as well as the robust 1999-00 grindings and return to bear market obscurity.

Although there have not been any fresh reports from reliable European analysts in the past few weeks, traders are now seriously doubting whether even 1.2 million tonnes can be reached, with estimates as low as 1.1 million tonnes beginning to surface. The most recently available statistics show that port arrivals of the main crop stand at 625,000 tonnes compared with 700,000 tonnes at this time last year.

Arrival figures can be deceptive at this time of the season because, as the name denotes, it is only an indication of what has arrived at port and not what might still be in the back country. Still, until the beans do appear, the market is correct in assuming that slower arrivals are indicative of a smaller crop.

This bull move does not need to rely solely on positive developments on the supply side, however, because the demand side is also shaping up just fine. The grind data released last week showed consumption to be progressing at a rate that is probably stronger than E.D.&F. Man's forecasts of 7.9% for 1999-00 (December 14) and 2% for 2000-01 (November 14).

Germany, whose grind had been expected to fade slowly as much European grinding activity shifted to Dutch facilities, surprised the market with growth of 18.9%. For the year, the German grind was up 14.7%. The pan-European grind followed, rising 7.5% for the quarter and 9.6% for the year, in line with expectations. The one disappointment came from the United States, where the grind fell 1.9% for the quarter. Traders were expecting a rise of about 5%.

Still, between these three key grinding regions, grindings were up 10% for the quarter. If we use these three regions as a proxy for all grindings – which is actually a conservative approach, because grindings in origin countries are growing a fairly rapid pace – it would seem that Man understated even its upwards revision for 1999-00. Man would have to expect a sharp enough drop in the next couple of quarters to bring annual grindings for 2000-01 back to a growth rate of only 2%.

The chocolate industry in Russia and China is still in its infancy, and as such any figures are – at the moment anyway – statistically insignificant. For example, it was reported that imports of cocoa beans and products into Russia for the first 7 months of 2000, were up 34% from the year-earlier period. This increase represented the bean equivalent of about 10,000 tonnes. In China, imports were up 40% for the first 11 months of the year, for an increase of about 8,000 tonnes. If this trend were to continue, however, Chinese and Russian data would indeed become significant.

The Commitment of Trader data released Friday afternoon show that speculative commodity funds covered 4,615 shorts, but did not reverse to the long side. Commercials increased their short positions. The little guys, surprisingly, sold into the rally, with their long position actually decreasing by 1,627 contracts. To us, this means that there is ample buying power on the sidelines. Sentiment numbers remain moderate.

As illustrated, the fundamentals have turned, and this is no longer a bear market. The deficit is more likely to be in the 200,000-250,000 tonne range. We've got the bears on the run.

[January 22, 2001]

CURRENT STRATEGY: *Remain long March cocoa as per flash update of December 21. Raise stops to 920, close only.*

SOY COMPLEX

Sliding prices aren't telling the whole story

Just one month ago, when the market was absorbing the Mad Cow disease story, soybean and soybean meal prices were looking quite healthy. Fresh contract lows were the last thing on the minds of soy complex participants (Chart 1). Despite the fact that hard evidence of increased demand surfaced promptly in the form of US export statistics, traders shifted their attentions to the progress of South American crops.

In its January supply/demand situation report, the USDA estimated Brazilian and Argentinian production at 34.5 and 23.5 million tonnes respectively, a combined 5 million tonne, or 9% increase over last year. Precipitation in Brazil has been ideal throughout the growing season. Some Argentinian growing regions struggled at times, but rainfall in January has been generous enough to replenish moisture levels. Private forecaster *Oil World* estimates Argentina's crop to be as large as 24.4 million tonnes.

It seems, however, that the market may have set aside the potential ramifications of the rush of US export business that followed the Mad Cow affair. Back in November, the USDA pegged US exports for 2000-01 at 25.86 million tonnes, compared with 26.49 million tonnes in 1999-00. The USDA did anticipate the increase in purchases that would result from the ban of the use of bone and meat meal as an animal feed. It raised its forecast for annual exports in December to 26.54 million tonnes and maintained this figure in the January report as well. Perhaps the USDA is being somewhat conservative.

On December 21, bean export commitments were running 12.8% ahead of the previous year's pace. Meal commitments were behind by 8.5%. As of this past reporting period, bean exports have jumped ahead of the comparable period last season by 16.6%. Even meal exports are now 8% *ahead* of last year.

Average weekly soybean commitments for December and January were 835,000 tonnes. To achieve the USDA's rather modest forecast of 26.54 million tonnes, US exports would average only a bit more than 200,000 tonnes per week for the remainder of the year. Commitment data now show that US exporters have already sold 2.8 million tonnes more than at this time last year.

To be sure, it would be optimistic to expect exports to maintain the momentum they currently enjoy. For the past two weeks, meal commitments ran dramatically above the norm at 355,000 and 433,000 tonnes, compared with an average of 211,000 tonnes during December and January – clearly an unsustainable level.

Although the December rally was driven almost exclusively by the Mad Cow issue, the increase in usage was not necessarily a temporary phenomenon. The popular press has been covering the Mad Cow issue recently. There is a possibility that consumption of beef will suffer to some degree. The beneficiaries would be soybean-meal-consuming hogs and poultry. While per-capita beef and pork consumption has remained stagnant in a health-conscious US over the past 10 years, poultry consumption has risen by 25% since 1990.

Even if we were to assume that the USDA was astute in making cautious forecasts, we believe that the current slide in prices does not fairly represent the global supply/demand balance. World ending stocks are estimated at 23.18 million tonnes, or 13.8% of consumption. This compares with 14.8% at the end of last season and an average of 15.7% over the past 10 years.

While one could argue that this is merely symptomatic of the just-in-time inventory culture that consumers of commodities have come to rely on, we would counter that this is exactly our point. It works well when weather, consumption patterns, production capacity, etc. behave as expected. It is of little use when surprises creep up. (Witness the natural gas market, for example.) At the end of the 1995-96 season, soybean stocks stood at a very similar 13.5% of consumption. By mid-1997, the market had run up to $9 per bushel.

We find it difficult to justify the current weakness. Rather than attempt to pick a bottom, we will observe from the sidelines and wait for an opportunity. *[January 30, 2001]*

STRATEGY: *Stay tuned.*

**Chart 3 –
March Soybeans**

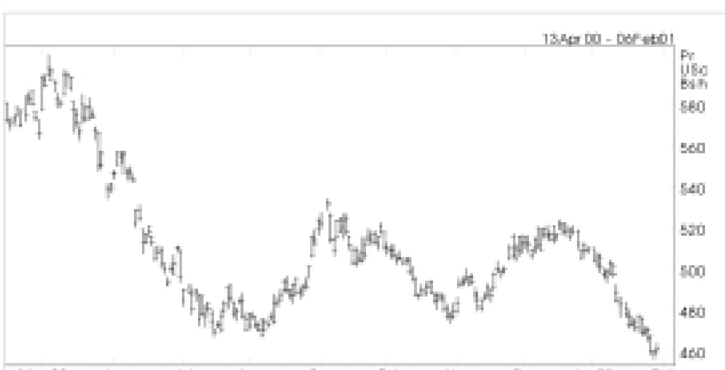

Chart courtesy of *Reuters*

HOTLINE UPDATE

Flash Update, Tuesday, January 2, 2001:
Good morning for Tuesday, January 2, 9:10 am. This is a Flash Update. We have liquidated our long February gold at 269.70.

Friday, January 5, 2001:
Good afternoon for Friday, January 5, 5:15 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long March cocoa, with our stop at 728; short March copper, with our stop revised to 83.50; and long March soymeal, with our stop at 182.70. All stops are close only.

Flash Update, Tuesday, January 9, 2001:
Good morning for January 9, 10:20 am. This is a Flash Update. We have covered our short March copper position at 83.50.

Flash Update, Thursday, January 11, 2001:
Good morning for Thursday, January 11, 10:15 am. This is a Flash Update. We have purchased March copper at 83.35, placing our initial stop at 86.35, close only.

Flash Update, Thursday, January 11, 2001:
Good morning for Thursday, January 11, 11:15 am. The following is a Flash Update, and a correction to our Flash Update of earlier this morning. We have liquidated our long March soymeal position at 181.80. We repeat our corrected Flash Update of earlier this morning where we purchased March copper at 83.35, placing our initial stop at 80.35, close only.

Friday, January 12, 2001:
Good afternoon for Thursday, January 12, 4:30 pm. The following is a recap our current open position recommendations and our latest stop levels. We are long March cocoa, with our stop revised to 750, and long March copper with our initial stop at 80.35. All stops are close only.

Flash Update, Wednesday, January 24, 2001:
Good morning for Wednesday, January 24, 10:15 am. This is a Flash Update. We have purchased March wheat at 284 3/4, placing our initial stop at 278, good anytime.

Flash Update, Friday, January 26, 2001:
Good morning for Friday, January 26, 9:15 am. This is a Flash Update. We have sold short March silver at 481, placing our initial stop at 495, close only.

Flash Update, Friday, January 26, 2001:
Good morning for Friday, January 26, 10:35 am. This is a Flash Update. We have liquidated our long March wheat at 467 1/4. We repeat our Flash Update from earlier this morning where we sold short March silver at 481, placing our initial stop at 495, close only.

Friday, January 26, 2001:
Good afternoon for Friday, January 26, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March cocoa, with our stop at 750; long March copper, with our stop revised to 82.35; and short March silver, with our initial stop at 495. All stops are close only.

Friday, February 2, 2001:
Good afternoon for Friday, February 2, 4:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long March cocoa, with our stop revised to 920; long March copper, with our stop at 82.35; and short March silver, with our stop revised to 488. All stops are close only.

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Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 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
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1901
New York, N.Y. 10005
(212) 943-5300