

# FRIEDBERG'S

## FOCUS ON FUTURES

Friedberg Commodity Management Inc.



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## Sugar: betting against the trade

While the presence of an inverted commodity market indicates a very tight supply situation, there is a flip side to this relatively unusual configuration. Commercial traders pressure forward contracts with their willingness to hedge future output at steep discounts to the cash market because they believe that the tightness in the nearby contract is temporary and that supply will be abundant in the future. It would be convenient to dismiss the current backwardation in the sugar market as such. Indeed, logical arguments exist to support this idea.

The market is still saddled with carryover stocks equal to close to half of annual global consumption. India has the largest stockpile, with an estimated 11.7 million tonnes of inventories at the end of the 2000-01 season. Last year it exported just over 1 million tonnes, but the government liberalized the sugar industry late last year and has allowed the opening of futures exchanges, which is expected to pave the way for increased exports.

On the surface this would seem to be rather bearish for prices and possibly explains in part why July sugar is trading at a 17% discount to March. Market talk has it, however, that there is little incentive for India to sell sugar on the export market with prices so low. So while the overhang of the Indian stockpile may be a factor at higher prices, it is not expected to play a significant role with world sugar prices trading at 8¢ per pound.

In addition, Mother Nature was not kind to the 2001-02 Indian crop, with drought reducing yields in key growing regions. Recent estimates put the crop at 16.8 million tonnes, down 700,000 tonnes from estimates released as recently as November and down 1.7 million tonnes from the 2000-01 crop. The population of India has ballooned to over 1 billion people, and its needs have grown. Consumption is estimated to grow in the 2001-02 season to between 16.5 and 17 million tonnes from last season's 16.3 million tonnes.

Brazilian output made a smart comeback in 2001-02 with a crop of close to 19 million tonnes, allowing the country to reestablish its reputation as the number one exporter in the world. With nearly four months still left in the marketing year, exports have already reached close to 9 million tonnes, compared with a total of only 7.4 million tonnes for all of 2000-01. The 2002-03, crop, which will be harvested starting in May, is

expected to be even larger than last year's. Here again we find part of the reason for discounted prices for delivery months in which the new Brazilian crop will be available.

We believe the market is a tad optimistic, however. We haven't seen any firm forecasts for the size of the 2002-03 Brazilian crop, but talk is that output in the Center/South region, where about 85% of the country's sugar is grown, is expected to increase by more than 10%. But a government report says that with the alcohol-to-gasoline ratio at 24% (every 2 percentage points uses the equivalent of 1 million tonnes of sugar), the exportable surplus for 2002-03 would be 10.6 million tonnes, not a great improvement on 2001-02.

We're no smarter than the analysts who count the crops – in fact we put our faith in their skills and integrity. The information that commercial traders are using to price the forwards is telling us that both the EU and Brazil will have good crops and ample supplies available for export in the coming months. The discounted futures, however, are trading

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at prices that make the market vulnerable to any crop accidents or better-than-anticipated demand.

We do know that there is a bona fide tightness in the whites market, primarily because of the nearly 2-million-tonne drop in the EU crop this past year. The entire rally that began in October has been accompanied by an explosion in the spreads. This is vividly depicted in Charts 1 and 2.

We cannot attribute the strength to speculation. As of the most recent Commitment of Traders report, neither of the speculative groups are sticking their necks out very far. Commodity funds are still climbing out of a short position and are just about flat, while small specs are net long 6,000 contracts. At one point during the rally this past spring, the funds had a net long position that was as large as 21,000 contracts. Small specs were net long 16,000 contracts at the time.

Finally, China imported 1.2 million tonnes of sugar in the calendar year 2001. With its entry to the World Trade Organization, it will be required to import 1.764 million tonnes in 2002. We suppose it will be difficult to know exactly how that will work. Regardless, the country is coming off a disastrous crop of 6.2 million tonnes, compared with its normal-sized crop of 7.5 million tonnes, and we expect imports to continue at a healthy clip.

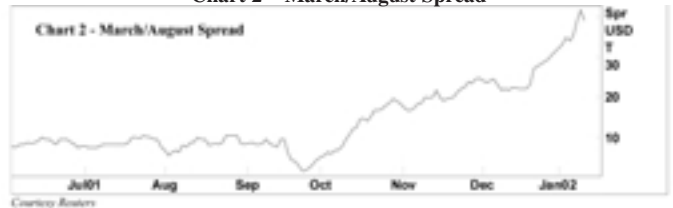
We recommend staying long May as a compromise between capturing the steep discounts and reaping the benefits of the squeeze that seems to be developing. [January 11, 2002]

**CURRENT STRATEGY:** Liquidated long May sugar as per Flash Update of January 24. Maintain stops at 6.40 close only.

Chart 1 – March London Sugar



Chart 2 – March/August Spread



## GOLD

# Subtle, but golden, buying opportunities

Gold spiked to just shy of \$300 per ounce in the aftermath of the September 11 attacks. Despite the enormity of the geopolitical ramifications, the market retraced the entire move in short order. Prices then traded in a tight range between \$272 and \$282 per ounce, with very solid support at the \$272-per-ounce level. Earlier this month the market broke out above the \$282-per-ounce resistance level (Chart 3).

The move was attributed to the takeover battle between AngloGold Ltd. and Newmont Mining Corp. for Australia's Normandy Mining Ltd. Speculation was that if its bid succeeded (it did), Newmont would become the world's largest gold miner. Given its corporate policy of keeping production unhedged, the company would have to cover Normandy's hedges. Traders scrambled to cover shorts in anticipation of a further tidal wave of short-covering.

A cultural shift in the mining industry away from hedging should ultimately prove to be quite bullish. The battle for Normandy turned out to be a buy-the-rumor-sell-the-news affair, and Newmont's victory was greeted with a yawn. Still, there are significant implications for the price of gold in an environment in which mining companies themselves are bullish on gold. Rallies will be allowed to develop to their full potential.

Aside from this development, a run through a checklist of factors that should affect gold prices reveals that, on the surface anyway, there is not much to motivate investment in gold.

The basic supply/demand indicators show a well supplied market. With gold in a bear market for so many years, growth in mine output had been expected to flatten out eventually. It hasn't happened yet. In a report released on January 17, Gold Fields Mineral Services (GFMS) estimates that world gold production will increase by 1% in 2002. Weak economies have had a devastating effect on jewelry demand. GFMS estimates that global fabrication fell 7% in 2001, to 3,383 tonnes.

Central bank demonetization has been the primary cause for weak gold prices over the past decade. GFMS estimates that official sector net sales will remain steady at 458 tonnes in 2002, down only slightly from 2001. A mitigating factor to this statistic is that while Western countries have been selling their official sector gold holdings, other countries may have adopted a different attitude towards gold's place in a central bank's reserves. China's central bank, for example, released statistics this past week indicating that it held 500 tonnes of gold at the end of 2001, up from 383 tonnes at the end of 2000.

Inflationary pressures, as viewed by the investing public, do not exist. The market focuses on the recessionary environment and highly visible, headline-grabbing items such as falling energy prices. A glance at the very different courses being charted by headline US CPI (Chart 4) and core CPI (Chart 5) reflects how there have been inflationary pressures at work even during the depths of the economic woes that plague most of the world. This divergence lends credibility to hawkish economists who repeatedly point to the rampant

growth of money supply as an inflationary time bomb.

The non-investment fundamentals are mostly bearish. Production is still inching up, consumption is falling significantly, and central banks continue to sell. The only component of the market that is in the early stages of turning bullish is in the mining industry, which is currently in consolidation and which will eventually see curtailed production and much smaller hedge books.

Weak as it may seem, the bullish case rests on the fact that in the absence of any obviously bullish factors, gold prices have held quite strong. Gold has outperformed most other commodities with equally bearish fundamentals since January 2001 (Chart 6).

The most recent Commitment of Traders data show that commodity funds have increased their net long position during this rally by a whopping 24,000 contracts, to be net long just under 30,000 contracts. Small specs increased their net long position by 5,800 contracts.

While we typically view a buildup of speculative long positions as burdensome and ultimately negative for prices,

an argument can be made that the gold market is unique in this aspect because it is the only commodity that is purchased for long-term investment.

It is important to watch developing patterns in any commodity to ensure that the market does not stagnate while open interest builds with weak-handed speculators. However, we cannot analyze gold as we would agricultural or industrial commodities. Rather, speculative interest has accompanied and exacerbated all past bull markets in gold and will be an essential element if we are entering one now.

We believe that the gold market is slowly but surely building a head of steam as investors, large and small, have begun to shift increasingly significant portions of their portfolios back into gold. Instead of declaring unrestrained bullishness, we are recommending a moderate-size, sustainable long position, because our timing may not be perfect, if you can believe that. [January 22, 2002]

**STRATEGY:** Remain long February gold as per Flash Update of November 28. Maintain stops at 260, close only.

Chart 3 – Spot Gold



Chart 4 – US Headline Consumer Price Index

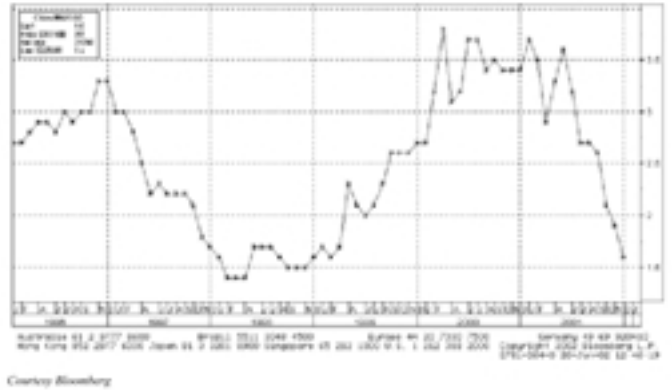


Chart 5 – US core Consumer Price Index

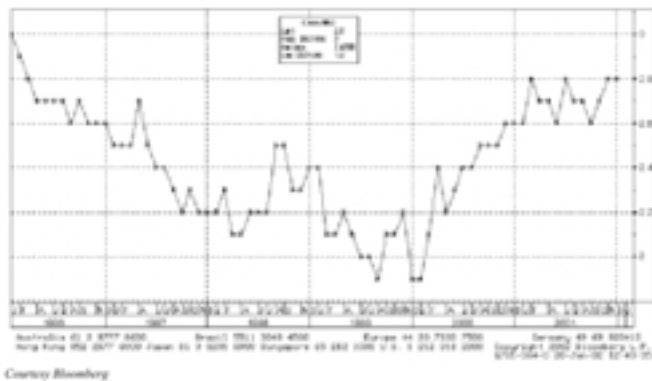
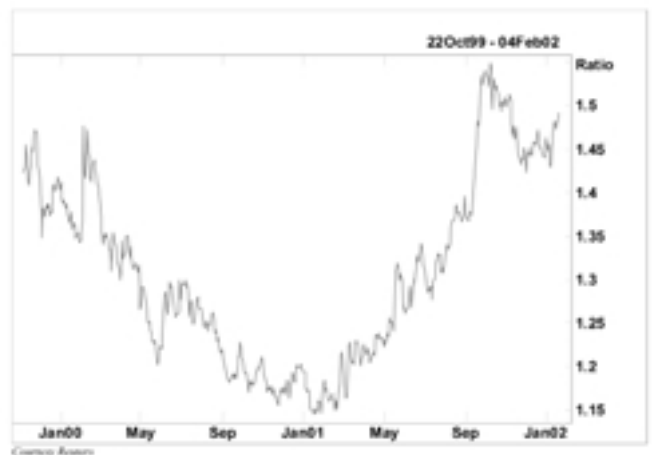


Chart 6 – Spot Gold vs. CRB Index



**WHEAT****Passing judgment on a correction**

The currency crisis in Argentina was the primary cause of the recent 35¢-per-bushel rally in wheat. Exporters held back supplies in anticipation of a currency devaluation that would allow them to exchange dollars received for far more pesos after the decade old US dollar peg was removed. The near-term tightness that was created by this situation inverted the March/May spread into a backwardation that peaked at 5.5¢ per bushel, a level not seen since March 1997 (Charts 7 and 8). The top of the rally and the inversion coincided almost exactly with the official announcement of the devaluation on January 12.

As we noted last month, developments for the longer-term fundamentals have not been particularly bullish. The USDA reinforced this with several substantial revisions in the January supply/demand situation report. The most bearish feature of the report was a surprise 8-million-tonne hike in 2001-02 Indian ending stocks, which was achieved by slashing domestic consumption by the same amount.

Estimates for FSU production continue to improve as they have every month since the marketing year began. The USDA raised its forecast by an additional 1.8 million tonnes over the December report. FSU production now stands at 91.66 million tonnes, compared with last year's 62.82 million tonnes. Together with the Indian revision, global ending stock were forecast to increase by 9.45 million tonnes, to 153.43 million tonnes. This represents a substantial increase in the stocks-to-consumption ratio from 24.16% in the December report to 26.05%.

We're not too concerned with the Indian revision. Last May the USDA shocked the market with a 30-million-tonne upwards revision to Chinese stocks. The monumental revision was certainly enough to terrify even the most committed bull. But that revision – as is probably the case with this month's Indian revision – did not create new supplies. Rather, it served as more of a revelation of how unreliable the data provided by Third World government agencies (on which the USDA relies on heavily for statistics) can be.

In any case, Indian analysts do not expect India to export more than 3 million tonnes in 2001-02, which would be 1.5 million tonnes more than in 2000-01, but not a staggering amount. An Indian exporter said in a press report last week that under certain favorable market conditions "...five million tonnes won't be a tall order." Bulls could live with that if that were indeed the extent of Indian exports. Besides, as far as quality is concerned, Indian wheat exporters cannot always compete in the same markets that US, Canadian, and Australian exporters do.

Despite the seemingly bearish international picture, we maintain a bullish bias. Although revisions have pushed global carryover stocks up to 153.43 million tonnes (26.05% of consumption) from estimates that were as low as 130 million tonnes (22.01% of consumption) in the August USDA report,

we are still below last year's 163.85 million tonnes (27.8% of consumption) and 170 million tonnes (28.84% of consumption) at the end of the 1999-00 season.

Also, there was a very bullish angle in this month's report. In its first look at the size of the US 2002 winter wheat crop, the USDA estimated that only 41.03 million acres were planted this past fall, compared with 41.08 million acres for 2001. US farmers have slowly been shying away from the winter wheat business, devoting acreage to more profitable pursuits. This was the smallest number of acres seeded since 1971. Consider that in 1990, 56.7 million acres of winter wheat were planted in the US.

Total production for the US, still the world's most important exporter of food-quality milling wheat, fell to 53.28 million tonnes this past season. This compares with 2000-01 output of 60.76 million tonnes and 1999-00 output of 62.57 million tonnes. Ending stocks are expected to decline to 18.26 million tonnes, or 29.7% of consumption. While this might still seem high, it is a sharp drop from last year's 36.5% of consumption and the previous year's 39.8%.

Shrinking ending stocks have been the result of supply factors, namely smaller crops, rather than growing demand. Exports for the season are forecast at 27.22 million tonnes, compared with 28.89 million tonnes last year and 29.65 million tonnes for the previous year. Earlier this season, exports were very strong, but they have tapered off. Commitments for the year stand at 19.07 million tonnes, compared with 20.29 million tonnes at this time last season.

This past week's export commitment of 668,000 tonnes surprised analysts, who were looking for a high-end of 400,000 tonnes, and broke a dismal string of sales. Average commitments for the previous 4-week period were only 336,000 tonnes. Next week's export report will be a very important piece of data to determine whether this week's robust figure was an anomaly or whether foreign buyers have returned.

Enduring bull markets typically require that the demand side of the balance sheet be strong. There is no overwhelming evidence that this is the case. Still, with the US supply situation in a bear market of its own and the potential for China to become a major buyer, the market would be in vulnerable position with even minor adjustments to either side of the balance sheet. Market action, including a shedding of 8,000 contracts of open interest, is consistent with our view that we are looking at a due-course correction in a long-term bull market.

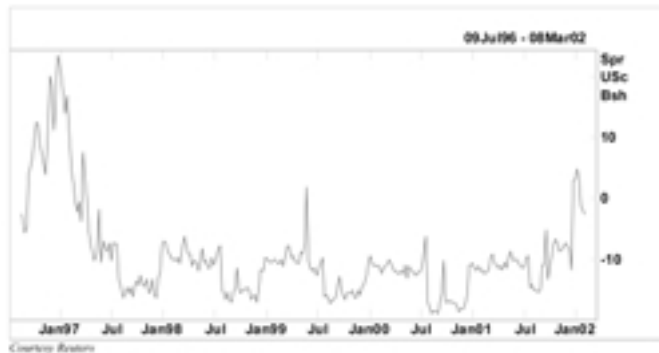
Having sat out the selling that followed the disappearance of the Argentinean factor, we are very close to reentering the long side. *[January 28, 2002]*

**STRATEGY:** *Stay closely tuned.*

Chart 7 – March Wheat



Chart 8 – March/May Wheat



## COCOA

### Consolidation for the cocoa bull

Cocoa prices have rallied over \$500 per tonne, or more than 50%, since mid-summer. After a brief stint north of the \$1,400-per-tonne level, the market has consolidated and is trading at the same price as it was at the end of December (Chart 9). Have the bullish fundamentals run dry?

The huge advance reflects primarily the acceptance by the market that the crop size of the world's largest producer, the Ivory Coast, is in decline. Despite reports that port arrivals have been at least as large as last year's, it is widely believed that the balance of the season will see sharp reductions to this pace. The most recent data show that arrivals stand at 720,000 tonnes versus 650,000 tonnes last year at the same time. The appearance of lower quality beans is used by analysts to establish that arrivals from the main crop are tapering off, and those beans have begun to show up.

The Ivorian main crop is now being pegged at between 950,000 and 980,000 tonnes. Even if we use the higher figure and add a generous mid-crop of 200,000 tonnes, the Ivorian crop would total 1.18 million tonnes, more than 50,000 tonnes below E.D.&F. Man's December forecast of 1.235 million tonnes.

This is not a market that receives a constant stream of fresh, relevant data. What information there has been lately can best be described as neutral.

Bulls have had their fill of supply data that has been friendly to their cause this growing season and were hopeful that as the demand situation became clearer, the bull case would be reinforced.

Quarterly grind data, however, was definitely disappointing. The pan-European grind for the fourth quarter, published early last week, was 164,825 tonnes, down 10.88% over the fourth quarter a year earlier. The fourth-quarter US grind, released on Friday, was 105,489, 2.88% lower than for the same period the previous year.

Traders shrugged off both items with the excuse that both figures were in line with expectations. The one positive note in the US report was that the liquor melt was more than triple last year's level and at a three-year high.

Another item that came up late last week seemed quite bullish on the surface. The Ghanaian government's cocoa industry regulator, Cocobod, said it was slashing its estimate of the 2001-

02 output to between 330,000 and 350,000 tonnes from 400,000 tonnes. However, the agency also said that the reduction had little to do with the actual crop. There is a bustling smuggling business across the Ivorian/Ghanian border. Ghanaian traders can receive the equivalent of US88¢ per kilogram in the Ivory Coast versus the farmgate price in Ghana of US58¢. Eventually, though, the smuggled beans will show up at Ivory Coast ports.

Still, the situation in Ghana bears further monitoring, because there was already a sharp downwards revision earlier this season on account of poor weather and persistent disease issues. The possibility exists that the current revision may contain actual crop loss as well. There is no hard evidence of this – it is just that the amount cited as smuggled seems like a fair bit.

The most exciting aspect for bulls is the backwardation. It is a great challenge to explain how a market that allegedly has such burdensome carryover stocks can maintain an inversion with the tightness it implies – currently at 147 points for the 1-year spread – that has never been this wide in modern history (Chart 10). This calls into question not only the amount of carryover stocks, but the quality of those inventories.

Open interest has been rising without progress in price, a pattern that typically makes us worry that we are taking the same side as weak-handed speculators rather than market moving commercial participants. The most recent CFTC data, however, show moderate, but constructive, changes for all three categories. Commodity funds and small speculators reduced their net long positions, which were not overwhelming to start with. For that matter, the fund long position is actually smaller now, at 4,179 contracts, that at 5,651 contracts when we last made the point on December 20. Speculators have not really gotten excited about this market yet. Commercial traders reduced their net short position by 1,377 contracts.

We are satisfied that market has reacted well to the few neutral and possibly bearish developments cited above. We look for the consolidation to be resolved soon with much higher prices.

[January 28, 2002]

**CURRENT STRATEGY:** Remain long March cocoa as per Flash Update of December 12. Raise stops to 12.50, close only.

Chart 9 – March Cocoa

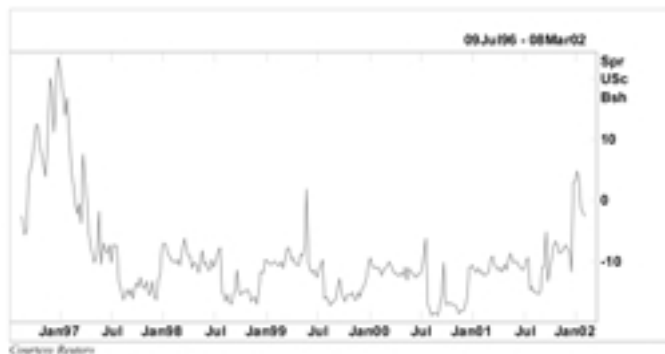
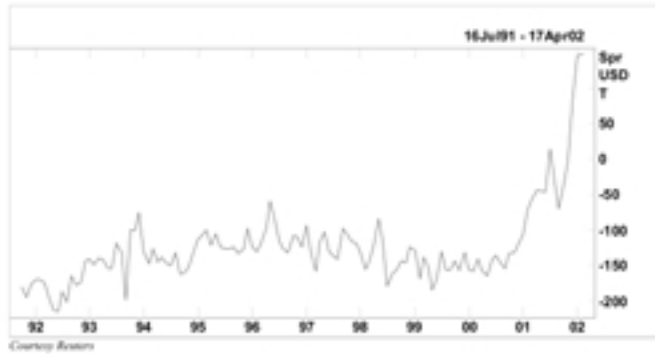


Chart 10 – Front Month Cocoa/1-Year Forward



## HOTLINE UPDATE

### Friday, January 4, 2002:

Good afternoon for Friday, January 4, 4:05 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long February gold, with our stop at 260; long March wheat, with our stop at 278.5; and long March cocoa, with our stop at 1190. All stops are close only.

### Flash Update – Monday, January 7, 2002:

Good morning for Monday, January 7, 9:05 am. This is a Flash Update. We have purchased May sugar at 6.90, placing our initial stop at 6.40, close only.

### Flash Update – Monday, January 7, 2002:

Good afternoon for Monday, January 7, 5:00 pm. This is a Flash Update. We have sold short March mini S&P at 1167, placing our initial stop at 1179, close only. We repeat our Flash Update of this morning, where we purchased May sugar at 6.90, placing our initial stop at 6.40, close only.

### Friday, January 11, 2002:

Good afternoon for Friday, January 11, 4:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long February gold, with our stop at 260; long March wheat, with our stop at 278.50; long March cocoa, with our stop at 1190; long May sugar, with our initial stop at 6.40; and short March mini S&P, with our initial stop at 1179. All stops are close only.

### Flash Update – Tuesday, January 15, 2002:

Good afternoon for Tuesday, January 15, 4:55 pm. This is a Flash Update. We have liquidated our long May wheat positions at 305.5.

### Friday, January 18, 2002:

Good afternoon for Friday, January 18, 5:10 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long February gold, with our stop at 260; long March cocoa, with our stop at 1190; long May sugar, with our stop revised to 6.68; and short March mini S&P, with our stop at 1179. All stops are close only.

### Flash Update – Thursday January 24, 2002:

Good morning for Thursday January 24, 9:00 am. This is a Flash Update. We have liquidated our long May sugar position at 6.58.

### Friday, January 25, 2002:

Good afternoon for Friday, January 25, 3:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long February gold, with our stop at 260; long March cocoa, with our stop at 1250; and short March mini S&P, with our stop at 1179. All stops are close only.

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