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Are bullish copper fundamentals sustainable?

In a departure from a well-entrenched pattern, the copper market defied its relationship with the equity markets over the past couple of sessions by maintaining a rally despite a sharp setback in stock indexes. March copper posted a 6-week high, while the Dow Jones Industrial Average gave back some 140 points of its recent rally. If nothing else, the anomaly of the market action should boost the confidence of copper bulls.

The International Copper Study Group (ICSG) released its most recent report on January 10. The report showed that the global surplus for the January-to-October 2002 period declined to only 6,000 tonnes. This is down from 90,000 tonnes in ICSG's October report for the January-to-July period, and dramatically lower than the 431,000-tonne surplus for the January-to-October period 2001. In October alone there was a production/consumption deficit of 62,000 tonnes.

The reduction of the surplus was achieved by significant bullish adjustments to both the supply and demand sides. Refined production for the 11-month period fell by 183,000 tonnes, or 1.4%, while consumption increased by 242,000 tonnes, or 1.9%.

Demand in the US and Europe was lacklustre for most of 2002, and much of the growth in consumption that we did see was attributable to strong demand from China, particularly for use in infrastructure projects. After a very busy year, Chinese imports slowed in October. It was quite encouraging to find in the ICSG report that the slack was picked up by EU importers, indicating an environment of more balanced demand.

These statistics are concrete and have certainly tightened up the copper balance sheet. But can we maintain consumption growth and contain production growth?

Economic data in the US have been steady, but only that. Industrial production rose 0.1% in November, but fell 0.6% in October. Economists expect December data, due out this Friday to show that industrial production grew by only 0.1% in December. The average of the past three months' data in the EU shows no growth in industrial production at all. In Japan, November industrial production was down 2.2%. All in all, economic data in the key centers that would be sensitive to copper consumption are not that inspiring.

Another area of concern for bulls is Chilean output. In 2002 Chilean production fell by 150,000 tonnes, or 3.2%, to

4.6 million tonnes. Production cutbacks in the world's largest copper miner were in large part responsible for putting a floor under copper prices and fueling the current rally. But that trend may be short-lived. Analysts are forecasting an 11% increase in production for 2003. Escondida, the world's largest copper mine, has expanded its operations and is expected to produce an additional 500,000 tonnes this year. Both Escondida and Codelco have indicated that they are going to hold back supplies from the market so as not to flood the market. If prices remain firm, however, it is difficult to envision that they will not rationalize – sooner or later – that the market could absorb the increased supply.

Some evidence has already emerged that Chile's participation in curtailing the supply side is over. Escondida output for 2002 was down 4.6% from 2001. In viewing data from the past two months, however, we find that the era of falling output may well have ended. November output was 12% higher than November 2001, and December output – released just this morning – was a startling 57% higher than December 2001. For all of Chile, output for July through August fell an average of 7.3%, but in November, the last month for which data are available, output was down only 0.5%.

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In conclusion, with almost no surplus left in the market, current market strength is well warranted. But the future is not as clear. Consumption will have to grow at a faster clip than 2% per annum to eat into the fresh output that is expected to hit the market, and indeed – as illustrated – may have already begun. We maintain a bullish bias because of

the great strides accomplished on the global balance sheet, but having missed buying the market “well” and owing to the uncertainties that lie ahead, we will observe from the sidelines. [January 16, 2003]

STRATEGY: *Remain sidelined.*

COTTON

Bullish outlook, but US export market must perform

The global cotton balance continues to tighten, according to the January USDA supply/demand situation report.

The most significant revision to 2002-03 data was to US output. Average trade estimates were calling for an upwards revision of 300,000 bales from the December report, to 17.68 million bales. Traders were rather surprised when the actual figure came in at 17.14 million bales, 240,000 bales below last month's production estimate.

Although 2002-03 global production and consumption were little changed from last month, the estimate for ending stocks fell further, due mainly to a sharp, downwards revision to 2001-02 ending stocks of 760,000 bales, to 46.63 million bales, or 49.3% of consumption. For 2002-03, ending stocks are estimated to fall to 37.92 million bales (39.3% of consumption), 920,000 bales below last month's estimate (40.3% of consumption). At 39.3% of consumption, ending stocks are the lowest they've been since the end of the 1994-95 season, when ending stocks fell to 33.4% of consumption and cotton prices soared to more than \$1 per pound.

On the surface, the market possesses all the components necessary for the bull run to continue. Production is expected to fall 11% from the 2001-02 season, and consumption will jump to a record 96.39 million bales, 2% above last season's output, leaving carryover stocks, as illustrated, at their lowest level since the mid-1990s. Yet the market seems to be stuck at current levels. The market traded above the early November highs but ran into solid overhead resistance and has fallen back below the recent trading range (Chart 1).

One of the issues that – at the moment – keeps us somewhat apprehensive about moving onto the long side, despite the apparent bullish developments, is the US export picture. It is the same concern we voiced in our Dec. 3 issue. Indeed, we join most market observers in the very same analysis.

In 2001-02, the US was by far the world's largest exporter of cotton, shipping a record 11 million bales overseas. The USDA estimates 2002-03 exports will be just slightly below last season's, at 10.8 million bales. Export commitments to date, however, are running about 2 million bales behind this time last year. To illustrate how important US exports are to the total picture, consider that the last time exports were anywhere close to 10 million bales was in the 1994-95 season mentioned earlier, when the US shipped 9.4 million bales and prices skyrocketed.

The only encouraging factor is that sales were brisk last week, with solid, above-average sales of 284,000 bales. To some degree, we are closing the gap between this year's and last year's sales. Commitments are now 22% behind last year's pace, whereas at the beginning of December they were lagging by 28%. The marketing year extends through the end of July, and we would require average sales of about 120,000 bales per week to reach the USDA target, not an overwhelming amount.

In viewing the market through US exports, the very exciting global ending stocks figure is a little less interesting for bulls until we are able to understand what to make of the USDA's persistence. If we were to project the current export pace over the whole season and deduct about 20% from the USDA's 10.8 million bales, ending stocks would rise to about 40 million bales, moving back to a not-quite-so-bullish 41.5% of consumption.

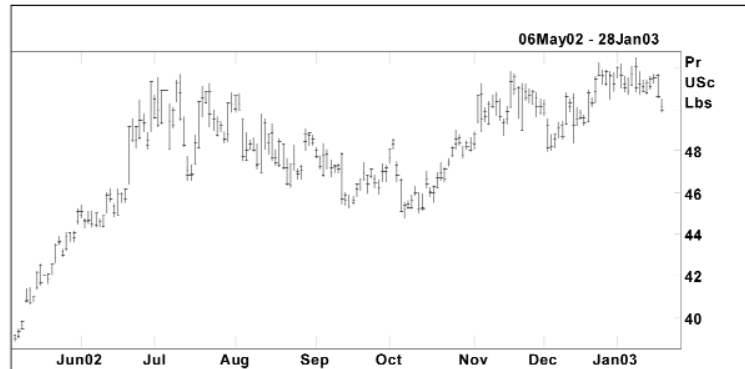
Two issues that have little to do with the long-term fundamentals but that are considerations for the shorter run should keep bulls cautious. Starting with the May contract, the New York Board of Trade has instituted more stringent requirements for delivery. (If you'd like to know more about the details of the upgraded requirements, send me an e-mail at ssanik@friedberg.com.) It is expected that there will be a rush to deliver the lower quality cotton against the March contract, which should put pressure on the market until March is off the board.

The other impediment has no time frame. Specs, both funds and small traders, are very long this market. This puts the overhead resistance into sharper perspective. Commodity funds are strong enough to carry a market, but only so long as the commercial side plays along. If open interest continues to build, as it has, and the trend loses momentum, it becomes obvious that the funds have run out of ammunition, and a countertrend move will be triggered – sooner or later – to liquidate the speculative position.

In conclusion, the big-picture fundamentals are constructive for the bull side, but given the market's current state of stagnation we believe the market is pricey at these levels. If US export commitments in the coming weeks begin to prove the USDA's 10.8-million-bale estimate believable, we will become eager buyers. [January 22, 2003]

STRATEGY: *Stay tuned.*

Chart 1 – March cotton



Courtesy Reuters

SUGAR

Running out of steam?

Sugar prices have risen sharply since they bottomed this past July. (Chart 2). After the market took a brief, but steep, plunge in November, open interest increased by close to 50,000 contracts. Open interest was already very high in historical terms at the time of the November low, and now sits at a record 247,135 contracts (Chart 3).

Further analysis of the open interest shows clearly that the speculative community is doing all the buying. Commodity funds are net long 50,845 contracts (Chart 4), while small speculators are net long 31,913 contracts (Chart 5).

In itself, this configuration does not have to be bearish. There are two reasons, however, why it may bearish. First, the market has made no progress in close to three months while we took on all the extra baggage. Moreover, the fundamentals are not bullish enough – if at all – to make 8¢-per-pound sugar an attractive buy. Rather, we believe that speculative buying has been sufficiently persistent, first to run the market up to these levels and then to maintain a high-level price consolidation, even in the absence of bullish supply/demand factors.

There have been several bullish developments throughout the rally for bulls to lean on. In November, The China Sugar Association estimated that China would harvest a record crop of 9.5 million tonnes in the 2002-03 season. This estimate was in line with most that we've seen in recent months. Such a bumper crop would, of course, limit its import needs. Reports emerged, however, indicating that adverse weather conditions in some growing regions had caused significant crop loss of 300,000 to 400,000 tonnes.

Another factor that has supported prices is Middle Eastern buying. Countries in the region have been importing quantities far in excess of their typical needs because of fears that there will be supply interruptions of basic foodstuffs if war erupts. While these extra purchases may narrow surplus tallies in the

short run, they are not an indication of growing consumption patterns. In fact, whether there is a war or not, these countries will be well stocked with sugar and would import even smaller amounts in 2003 than they would normally.

Australia, an important supplier to Asian markets, is expected to suffer from the same drought conditions that devastated the country's winter grain and cotton crops – in some cases slashing output by 50% or more. Australian farmers would have to have surprisingly wet weather conditions to come even close to 2002-03 output of 5.1 million tonnes.

Spot supplies of white sugar are reportedly tight, and this is certainly reflected in backwardation in both New York and London (Charts 6 and 7). There seems to be a bit of a chink in the armor, though, because in recent days the spreads have narrowed, particularly in New York, where the March/May backwardation has fallen from a peak of 75, to 54 points at yesterday afternoon's close. This is not optimum behavior for a (potential) bull market at the threshold of breaking into new high ground.

On January 16, the market was attempting a bit of a breakdown when, shortly before the New York close, the wire services broke a story that a European-based analyst issued a report that lowered its forecast for the global 2002-03 surplus by 1 million tonnes from a previous estimate. The market loved the story, and by the next morning, March sugar sprinted to a fresh high not seen since early December.

One very important item that was missing from this report – and all global surplus estimates we have seen to date – is the development on the gasoline/ethanol ratio issue in Brazil. The ethanol component has been 25% for some time. This is close to the high end of the potential range, and as a result, ethanol stocks have been run down. In response, the Brazilian government has put legislation in place – to take effect February 1 – to bring the ethanol component all the way

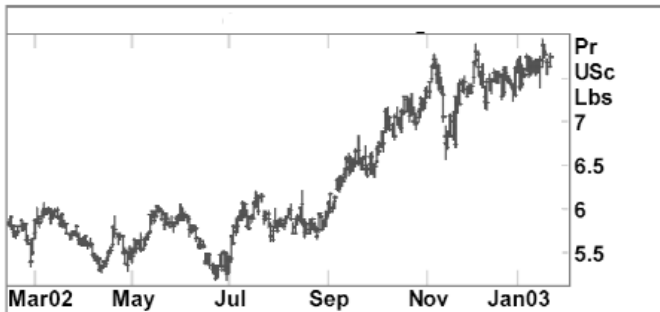
down to 20%, the low end of the range. Each percentage point change represents about 500,000 tonnes of sugar. The resulting drop in ethanol usage therefore makes 2.5 million tonnes of sugar available for the export market and effectively puts the global 2002-03 surplus back up to the 4- to 5 million-tonne surpluses we saw earlier this season. But the market continues to trade near the highs and pretends that the news out of Brazil never happened.

Aside from the Australian situation, the outlook for 2003-04 production seems fairly healthy. In Brazil, early estimates for the world's most important crop are for output to match or

exceed the bumper 2002-03 crop of 22 million tonnes. We believe that the issue of excessive open interest needs to be resolved – and will be as it always invariably is. The existence of a global surplus means that there is ample sugar to meet world trade requirements, and the strength in the market is primarily a result of a speculative bubble. We are trading this market from the short side, but we respect trends and will therefore use conservative stops. [January 24, 2003]

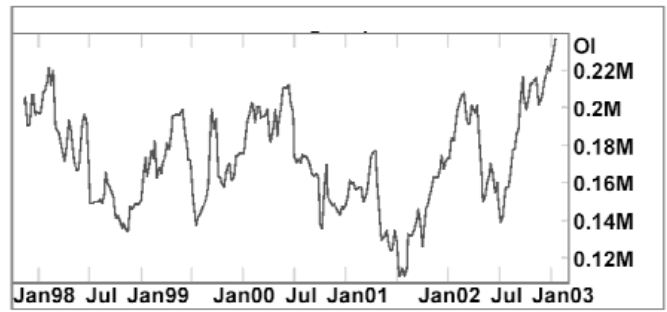
CURRENT STRATEGY: Covered March sugar as per Flash Update of January 24.

Chart 2 – March sugar



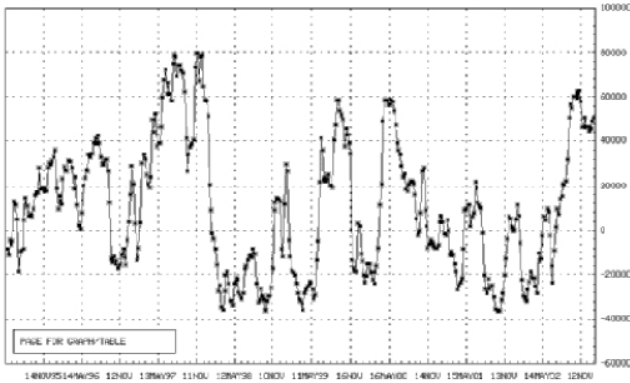
Courtesy Reuters

Chart 3 – Sugar open interest



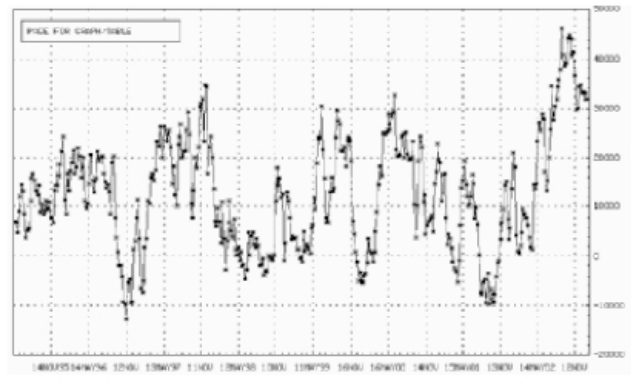
Courtesy Reuters

Chart 4 – Net long position of commodity funds



Courtesy Bloomberg

Chart 5 – Net long position of small speculators



Courtesy Bloomberg

Chart 6 – New York March/May sugar spread



Courtesy Reuters

Chart 7 – London March/May sugar spread



Courtesy Reuters

SOYBEANS**Outlook for soybean prices
turns negative with USDA report**

The January USDA supply/demand situation report altered the soybean landscape considerably, and just about all the revisions took market participants by surprise.

First in the US – the world's largest producer, and for the moment, the largest exporter – the 2002-03 crop was revised upwards by 1.09 million tonnes, to 74.29 million tonnes. Average trade estimates were for a small increase from the December report of 80,000 tonnes. Increased estimates of harvested area of 400,000 acres and yield of 0.3 bushel per acre were responsible for the increase in output.

The revision to the crop size was partly offset by an increase in the estimate for exports of 820,000 tonnes, but still resulted in a jump in US ending stocks of 400,000 tonnes from last month, to 5.16 million tonnes. While this is still below last year's 5.66-million-tonne carryout, lower domestic consumption and exports will expand 2002-03 inventories to 6.9% of consumption from December's 6.4%, narrowing the difference with 2001-02 stocks, which were 7.1% of consumption.

The quarterly grain stock report was equally disappointing for bulls. Trade estimates were looking for December 1 inventories of 56.7 million tonnes, but the street was off here as well. The actual figure came in 57.5 million tonnes.

Moving on to the global scene, last month our soybean article asked: "Can foreign production put a lid on soybean prices?" After studying this month's USDA report, it seems that this may be happening. It is becoming increasingly evident – at least according to the USDA – that the reportedly poor planting season did not hurt the prospects for crops in South America.

In Brazil, dry weather was a concern, but farmers are receiving ample rainfall as the growing season progresses. The resulting soil moisture levels have created ideal conditions for developing crops. The USDA maintained its 49 million tonne estimate for the Brazilian crop, 5.5 million tonnes, or 12.6%, larger than the 2001-02 crop.

It has been dry in Argentina, but an increase in the estimate for harvested area to 12.5 million hectares and a hike in the estimate for yields pushed the estimate for the crop up 1 million tonnes, to 33.5 million tonnes. This will be 3.5 million tonnes, or 11.6%, higher than last season. On January 22 the Argentinean agriculture ministry raised its estimate further to 34 million tonnes.

US export commitments have been fairly steady, with some particularly large sales lately, prompting the USDA to raise its estimate for annual exports from the December report by 820,000 tonnes, to 25.31 million tonnes. This is still substantially below last year's 28.92 million tonnes. In monitoring the progress of exports compared with last season, however, we find that sales are actually catching up. At the time of our last writing, commitments were running 5.7% behind the

same time last year. As of this morning's weekly export report, we are only 3% behind the same time last year.

The obvious problem with this is that as soon as South American supplies become available in early spring, the competition is likely to cut into US sales, making sense of the USDA's keeping its estimate for annual exports 3 million tonnes behind last year.

The above revisions have resulted in a shift in the global supply/demand balance. Ending stocks for 2002-03 will jump 1.3 million tonnes from last month's estimate, to 30.65 million tonnes, or 16% of consumption, up from last month's 15.4% of consumption.

Commodity funds and small specs were carrying a burdensome long position, so the intensity of the selling on the morning of the release of what was quite a bearish report was a perfect fit. The market wiped out all of December's gains in the first five minutes of the session. But that was it. March soybeans have retraced half the drop from the top. In an effort to keep losses to a minimum we liquidated our position a bit prematurely.

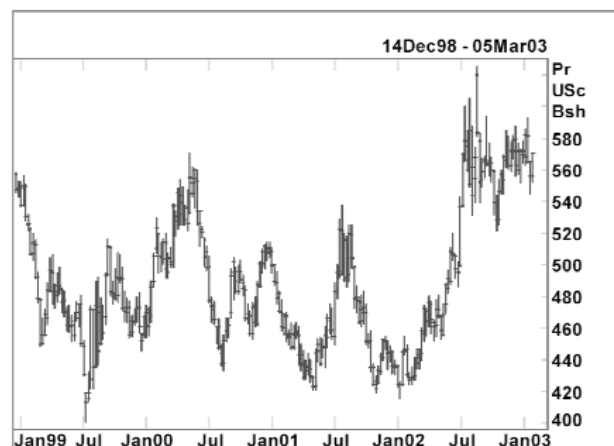
Two weeks have passed since the release of the January report and the market is still trading close to five-year highs, so the market is not cheap in terms of the revised statistics. Still, while the report made the picture look rather ugly for bulls, we should put the revisions in perspective. Global ending stocks are still lower than last year's 17.5% of consumption and 2000-01 ending stocks of 18% of consumption.

We're out for now, but we will be watching the US export market and the development of South American crops with great interest.

[January 26, 2003]

STRATEGY: Liquidated long March soybeans as per Flash Update of January 16.

Chart 8 – Weekly soybeans



Courtesy Reuters

HOTLINE UPDATE

Friday, January 10, 2003:

Good afternoon for Friday, January 10, 3:30 pm. The following is a recap of our current open position recommendations and our latest stop levels: We are long March soybeans, with our stop at 540; long February gold, with our stop at 315; and long March cocoa, with our stop at 1975. All stops are close only.

Friday, January 17, 2003

Good afternoon for Friday, January 17, 3:55 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On January 14, we liquidated our long March cocoa positions at 2061, on January 16, we liquidated our long March soybean position at 547.25, we are currently long February gold, with our stop at 315, close only.

Flash Update – Tuesday, January 21, 2003:

Good afternoon for Tuesday, January 21, 12:15 pm. This is a Flash Update. We have purchased July wheat at 311.5, placing our initial stop at 295, close only.

Flash Update – Wednesday, January 22, 2003:

Good morning for Wednesday, January 22, 10:15 am. This is a Flash Update. We have sold short March sugar at 7.62, placing our initial stop at 8.00, close only.

Flash Update – Friday, January 24, 2003:

Good afternoon for Friday, January 24, 12 pm. This is a Flash Update. We have covered our short March sugar position at 8.01.

Friday, January 24, 2003:

Good afternoon for Friday, January 24, 4:05 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On January 21 we purchased July wheat at 311.50; on January 22 we sold short March sugar at 7.62; on January 24, we covered our short March sugar position at 8.01; we are currently long February gold at 318.50, with our stop at 315; and we are long July wheat at 311.50, with our initial stop at 295. All stops are close only.

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