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Corn: demand is growing, supply is dwindling, the bull charges ahead

The December USDA supply/demand situation report contained a series of important surprises on both the supply and demand sides of the balance sheet, particularly for the US. The revised estimates have altered the landscape considerably. The report was greeted by traders with a rally that took corn prices right through the stubborn \$2.50-per-bushel resistance level, which has held since early this past fall (Chart 1).

In its final estimate for the 2003-04 US crop, the USDA slashed output by 4 million tonnes, to 256.91 million tonnes. The average of analysts' estimates was actually calling for a small upward revision from the 261.07-million-tonne December estimate.

On the demand side, most key usage categories were revised upwards. Industrial usage was increased by 750,000 tonnes, and the forecast for exports was raised by 1.27 million tonnes. Neither of these revisions came as a great shock (more on exports later). The biggest and most surprising revision was for feed use. After two mad cow scares – first the Canadian version and now the Washington State affair – beef production is expected to decline. The increase in pork and poultry output, however, is apparently growing at an even faster pace than the fall in beef output, compensating for the drop in corn consumption by cattle. Feed usage was increased by 1.9 million tonnes from the December estimate.

Considering the market's initial reaction to the first reported US case of mad cow disease, we've come an awfully long way. Prices first plunged on the news of the discovery of the infected cattle, and the last thing on anyone's mind was an *increase* in US feed demand.

As a result of these revisions, US ending stocks for 2003-04 will fall to 24.91 million tonnes, or 9.58% of consumption. This will be the second consecutive season with inventories at dangerously low levels. Average ending stocks as a percentage of usage before that – and going back to the season after the mid-1990s bull market ended – were 16.6%.

And there are not many alternatives for foreign buyers. South America was a mixed bag in this month's report. Brazilian production was raised by 2.5 million tonnes, but the estimate for exports was increased by only 1.5 million tonnes. Argentinean output was lowered by 1 million tonnes because

of poor weather, and exports were reduced by the same amount. The 500,000-tonne gain in exportable surplus is relatively minor in light of rapidly shrinking US ending stocks.

In response to China's de facto halt to corn exports (see *Focus on Futures*, January 2), Chinese exports were lowered by 500,000 tonnes, to 8 million tonnes. The small revision, however, does not tell the whole story. Much of the 8 million tonnes was already sold and shipped. This leaves only the US and South America with meaningful supplies available for export for the balance of the marketing year. China's absence from its traditional Asian export market could open up a whole new arena for US exporters.

Looking at the total global picture, ending stocks were revised down from last month by 6.75 million tonnes, and now stand at 67.5 million tonnes, or 10.5% of consumption, down from 11.66% last month. This compares with 16.2% for 2002-03 and 20.8% in 2001-02.

Hard evidence that the world is clamoring for US corn can be seen in commitment data, which show that sales continue to run well ahead of last year's pace. As of this past week's export report, commitments stand at 26.6 million tonnes, 29.8% ahead of last year at this time.

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A check of the commercial trading community's activity provides a more sobering perspective. Commodity funds have been rebuilding their long position, which obviously means that commercials have been obligingly selling into the rally. As we've explained many times in the past, a ballooning open interest is acceptable as long as the price is ballooning in tandem (or in a bear market, as long as prices con-

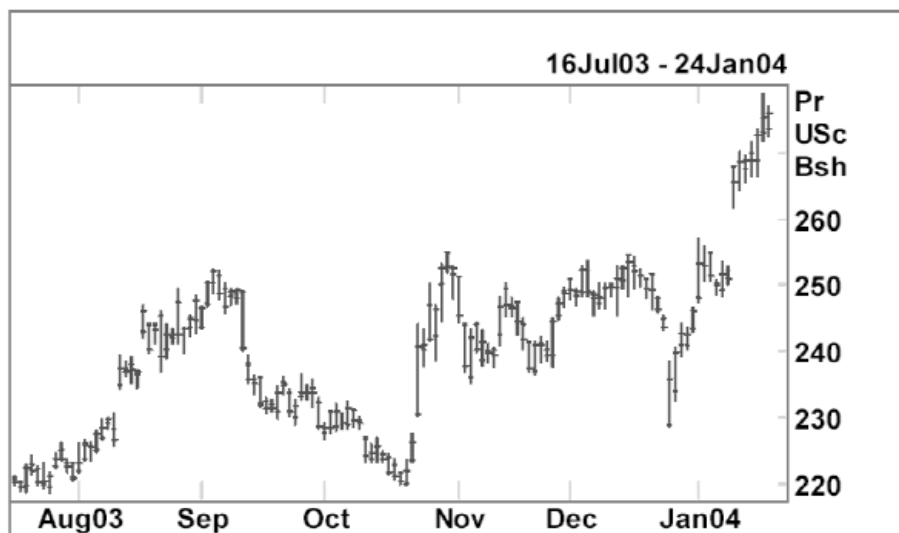
tinue to drop). Thus far, the bullish pattern is intact.

We lost our position after being stopped out in the mad cow selloff. We remain very bullish, however, and are waiting patiently for an opportunity to reestablish a long position.

[January 21, 2004]

STRATEGY: *Stay closely tuned.*

Chart 1 – March corn



Courtesy Reuters

COCOA

Grind figures are impressive, but Ivorian output looking up

Last month we pointed out that the cocoa market has been focusing all its attention on the political situation in the Ivory Coast. Certainly, this is well warranted, considering the African nation's status as the world's largest supplier of cocoa beans. But the market has been aware of the risks to the Ivorian crop for some time, and we could assume that a good deal of fear premium has already been built into the price.

Unreliable as it may be, on January 8, an Ivorian government official weighed in with a forecast of 960,000 tonnes for the 2003-04 crop, a dramatic drop from last year's 1.3-million-tonne crop. European analysts E.D.&F. Man and Credit Lyonnaise – who have made far more accurate forecasts than the Ivorian government in the past – have yet to release an estimate that would reflect potential output loss that may have resulted from the recent spate of unrest.

Port-arrival figures have been running below last year and have made it difficult to envision a bumper crop. Still, we're not convinced that we won't see a normal crop. During the 2002-03 season estimates of a normal crop size also seemed unrealistic, but arrivals increased as the season wore

on and a near record crop was shipped.

The most recent figures, released on January 20, show that arrivals have picked up some steam. In December, arrivals were about 20% behind last year's pace, but the new figure of 700,000 tonnes is about 12% shy of the same time last year. Factoring in the likelihood that there was a good deal more smuggling into Ghana this season, we're not running that far behind last year.

That's the supply side. We continue to believe that market participants are not placing enough emphasis on the possibility that the demand side is finally kicking in. Last month we highlighted the scarcely reported increase in butter ratios and we predicted that this is certain to show up eventually in grind results. Indeed, grind results have been coming in well above expectations. First, on January 7, the fourth-quarter German grind was released, showing a 12.3% increase over the same period last year, and nowhere near the 2% increase analysts had forecast. The pan-European grind, released on January 16, was up 6.7% over fourth quarter last year, also much higher than street guesstimates for a 3% increase. The

US grind figures have yet to be released.

Doing some loose arithmetic, if we use a growth-rate for grindings of 5% and tack on the additional consumption to Credit Lyonnaise's 2003-04 estimate of 3.054 million tonnes for world grindings, which was based on a forecasted grinding-growth-rate of 3.6%, the global production/consumption deficit would be about 70,000 tonnes. This would not translate into an appreciable difference in the global stocks-to-consumption ratio. The 2002-03 marketing year ended with stocks of about 38% of consumption. Increased grindings will bring 2003-04 ending stocks down to about 36.5% of consumption.

Still, the better-than-expected grind results could mean that we are dealing with a fresh set of dynamics that the market has not yet accounted for. The disappointing reality for

bulls is that the market action has been very negative for what should have been very bullish news.

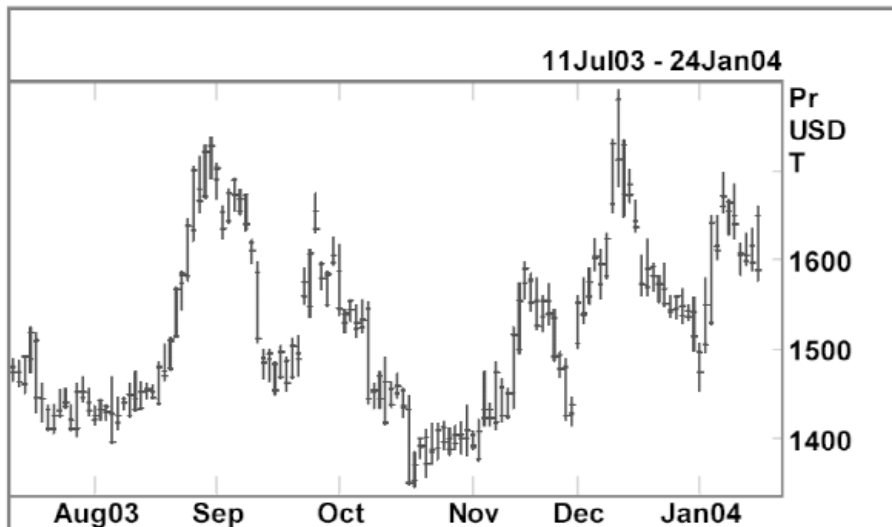
The market has been unable to mount a rally to new highs on the positive consumption news, possibly because these developments coincided with news that the Ivorian crop results are not as bad as previously believed – the primary concern of participants.

We have shifted from being downright bearish as recently as this past September (see *Focus on Futures*, September 1) to our current friendly posture. We're not quite ready to jump on the long side, but we do find the increased demand constructive for prices.

[January 21, 2004]

STRATEGY: *Remain sidelined.*

Chart 2 – March cocoa



Courtesy Reuters

SUGAR

Is sugar bottoming?

Over the past several years, the prices of a number of commodities that we follow – cotton, hogs, and cocoa to name a few – sank to unsightly, multi-year lows. The three examples cited have virtually no real relationship, but they had one thing in common when their prices were sinking. Their supply/demand fundamentals were very bearish, and none of them seemed to have any prospect for a meaningful price appreciation. Invariably, conditions for all the markets we trade eventually change, and these commodities were no exception. After hitting rock bottom, these commodities more than tripled in price.

Now, this is not to say that a commodity that is trading at multi-year lows should necessarily be traded from the long side. But we're in an environment in which commodity prices

have skyrocketed, and there are slim pickings if you're looking for value. The CRB index has risen 70% since the beginning of 2002 and has now slipped ahead of its 1996 highs. Sugar is one of the lone holdouts in this explosive commodity bull market. On the surface, things don't seem very different for sugar than they did for cotton at 28¢ per pound or cocoa at \$700 per tonne. Producers ultimately become wary of low prices, however, and either shift resources to other crops or are forced by virtue of simple economic realities to neglect crops, causing yields to fall. If demand exceeds expectations while supplies become less plentiful, the bear quickly becomes a bull.

One curious aspect of the sugar market is the activity in the open interest. Over the past few months, March sugar

has spent most of its time trading in a relatively narrow range of 6¢ to 6.5¢ per pound. Since December, prices have moved down from the top to the bottom of the range – not a great distance in the grand scheme of things (Chart 3) – and open interest has swelled by some 60,000 contracts, or more than 30%.

The most recent Commitment of Traders report shows that the commodity fund net-short position is almost as large as it was this past July and then again in November when the funds drove prices down. Both situations were met with 1¢-per-pound, counter-trend, short-covering rallies. The funds have succeeded in pushing the market slightly below the October lows, but it seems that it took a lot of energy for very little progress.

A more microscopic look shows us that March sugar made a new low on December 31 at 5.67, but the market has not been able to penetrate that low even while open interest has grown by about 38,000 contracts. The inability of the funds to push prices lower probably means that commercial traders are supporting the market. The funds will be forced to cover, sooner or later.

How about the fundamentals? The world's largest sugar producer and exporter, Brazil, continues to grow record crops. Output for 2003-04 is expected to reach 24.7 million tonnes, close to 1 million tonnes, or 4%, larger than the previous year. Brazil has ample supplies available for export, which has proven to be the single most crucial factor that determines the world sugar price.

A large portion of the crop is crushed into ethanol, most of which is consumed domestically. Ethanol is a cheaper fuel than petroleum as long as crude is trading above \$18. The ethanol market for automobiles in Brazil is well developed. It continues to grow domestically, and the industry is now push-

ing the successful program abroad. (In contrast, in the US, although more than 10% of the corn crop is turned into ethanol, the industry is still in its infancy and does not enjoy the commercial viability that ethanol fuel does in Brazil.)

Both the domestic and export market are expanding. Total output of ethanol in 2003-04 grew by close to 2 billion liters, or 15%. Export capacity has been reached, and a new facility is being planned specifically to expand export capacity by more than 20%. So while the export pipeline for the traditional sugar markets are flowing freely out of Brazil, new markets are being developed. We are not saying that Brazil cannot meet the demand now, but will it be able to if its best expectations for ethanol consumption are met?

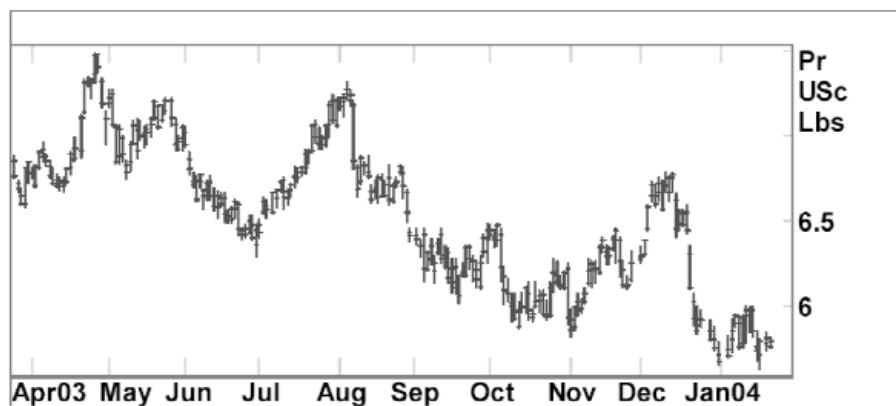
Over to China, import demand has disappointed sugar bulls over the past few seasons. But that is another highly vulnerable area. Consumption is estimated at about 10.3 million tonnes for 2003-04, but recent output figures have been lowered to about 9.5 million tonnes. If China's recent activity in the cotton and soybean markets is any indication, it is not likely to run down its inventories, and may very well increase its sugar purchases abroad.

Still, F.O. Licht's first estimate for the 2003-04 crop year is calling for a 2.8-million-tonne global surplus, albeit a much smaller one than last year's 10-million-tonne surplus. Ending stocks as a percentage of consumption will fall slightly, to 48.48% from 50.23% in 2002-03.

In conclusion, there is no extraordinary bullish case. However, given the combination of low prices, which have possibly been exacerbated by speculative activity, and a slightly tighter market, we have not ruled out getting our feet wet on the long side. *[January 22, 2004]*

STRATEGY: *Remain sidelined.*

Chart 3 – March sugar



Courtesy Reuters

WHEAT**Bullish fundamentals against a poor technical picture**

On January 12, the USDA released its first estimate for 2004 US winter wheat acreage. US farmers seeded 43.464 million acres, down from last season's 44.945 million acres and below the average analyst's guesstimate of 45.637 million acres. Along with a 660,000-tonne increase in the estimate for annual exports contained in the monthly supply/demand situation report released on the same day, it was fairly bullish slate of news.

The market's initial reaction was positive, rallying by as much as 20¢ per bushel over the two sessions following the report. By the end of the second session, however, prices settled right back into the trading range set before these bullish reports were published. March wheat failed to take out the previous near-term high of \$4.07 per bushel set on January 2 (Chart 4) and has made no progress since. This action is fairly disappointing to bulls, particularly in light of the fact that the open interest has swelled by about 28,000 contracts, or about 25%, since late December.

Although it is a bit early in the season and the press doesn't devote much attention yet to crop conditions, some key regions in the southern plains have been extremely dry. But even if we assume optimum yield results similar to last year's near record yields of 46.7 bushels per acre, we are still losing over 2.5 million tonnes of wheat for the 2004-05 marketing year, which would leave the new crop about 4% smaller than the 2003-04 crop.

Jumping overseas, and further developing the discussion we began in the December 24 issue about the potential for China to become a significant importer, we came across a very interesting story about new-crop acreage. Apparently, a large chunk of acreage will be shifted from wheat to far more profitable cotton and soybean crops. It estimated that winter wheat acreage will be as much as 5% lower than this past season. Using a rough calculation, this would translate into Chinese output for 2004-05 of about 82.5 million tonnes, 4.5 million tonnes smaller than 2003-04.

China has already purchased 680,000 tonnes of wheat from the US this marketing year, more than the 430,000 tonnes it imported from all countries in 2002-03. Together with other purchases from Australia and Canada, China has probably already exceeded the USDA's estimate for the 2003-04 marketing year of 2 million tonnes. The long awaited Chinese wheat buying tour is finally scheduled for arrival in the US in mid-February, and there will almost certainly be an announcement of additional purchases.

Back to the US, export commitments continue to run far ahead of last year's pace. As of this past week, sales stood at 23.47 million tonnes, 37% ahead of last year at this time. In response, the USDA raised its estimate for annual exports to 30.62 million tonnes, up 660,000 tonnes from last month's estimate.

It seemed that sales were slowing down after the first two reporting periods this month showed an average of a paltry 235,000 tonnes sold per week, compared with 670,000 tonnes in December. This week's report, however, alleviated any such fears. Combined old-crop and new-crop sales were an amazing 1.84 million tonnes.

The revised US export total was the only significant change in this month's report among all countries, but was enough to lower global ending stocks further to a new recent low of 127.26 million tonnes, or 21.5% of consumption, the lowest ratio since the 1972-73 season. While the US has ample supplies to meet demand at its current pace, we do not know what things would look like if China actually became a more active buyer.

In conclusion, while we are disappointed with the market action, we consider the overall fundamental situation extremely bullish. For the moment, we observe from the sidelines, but it will not require very much to get us long if we see any letup in what is an obviously, but temporarily, overbought condition.

[January 23, 2004]

STRATEGY: *Stay tuned.*

Chart 4 – March wheat



Courtesy Reuters

HOTLINE UPDATE

Friday, January 9, 2004:

Good afternoon for Friday, January 9, 4:40 pm. The following is a recap of our latest recommendations and stop levels: We are currently long February gold at 391.30, with our stop at 383; long March Japanese yen at 9171, with our stop at 8980; and long March cotton at 70.40, with our stop at 67.20. All stops are close only.

Flash Update – Wednesday, January 14, 2004:

Good morning for Wednesday, January 14, 9:20 am. This is a Flash Update. We have sold short March mini S&P at 1123.50, placing our initial stop at 1131, close only.

Flash Update – Wednesday, January 14, 2004:

Good afternoon for Wednesday, January 14, 4:10 pm. This is a Flash Update. We have covered our short March mini S&P position at 1131.

Friday, January 16, 2004:

Good afternoon for Friday, January 16, 3:40 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 sold short March mini S&P at 1123.50, and covered short March mini S&P at 1131. We are currently long February gold at 391.30, with our stop at 383; long March Japanese yen at 9171, with our stop at 8980; and long March cotton at 70.40, with our stop at 67.20. All stops are close only.

Friday, January 23, 2004:

Good afternoon for Friday, January 23, 3:35 pm. The following is a recap of our latest recommendations and stop levels: We are currently long February gold at 391.30, with our stop revised to 401.80; long March Japanese yen at 9171, with our stop at 8980; and long March cotton at 70.40, with our stop revised to 70.75. All stops are close only.

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