

# FRIEDBERG'S

## FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



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## Cotton: confusing technical signals, nothing unclear about the fundamentals

In previous issues we pointed to an intriguing feature of the cotton market: Price patterns over the past 16 months have defied traditional rules that normally serve as indispensable tools for trading commodity futures. Strong statements made by commercial traders – expressed by their position in the market – are almost always vindicated, sooner or later. In the case of cotton, however, commercials maintained a net-long position throughout a major slide in price, from 85¢-per-pound right down to the 42¢-per-pound low. This allowed commodity funds – which obviously took the other side of the trade – a very enjoyable ride on the short side. Clearly, this situation represented a noteworthy aberration in the annals of Commitment of Traders data.

At present, it would seem that commodity funds have declared they're done with the short side and that the market has seen its lows. The funds' position has swung from a net-short position of 33,224 contracts recorded on November 2, to a current net-long position of 1,720 contracts as of the most recent Commitment of Traders report.

Regardless of what happens from here on in, a lingering insecurity regarding trading signals generated by commitment data for cotton will exist for the foreseeable future. The observation we choose to make at this time, however, is that the 5¢-per-pound rally that began in mid-November was inexplicable in terms of the supply/demand fundamentals that we are aware of. The only reasonable explanation would be short-covering by commodity funds. As such, we believe that prices at these levels are not sustainable.

Although the global balance sheet continues to show an increasingly amply supplied market, for the most part, there has not been very much new in the way of bearish fundamentals over the past two months. The USDA estimate for the record US crop was revised upwards in both December and January and now stands at 23.01 million bales, 4.75 million bales larger than the 2003-04 crop.

The January USDA supply/demand situation report contained two other significant supply side revisions. Pakistani production was increased by 1.5 million bales, to 11.5 million bales. Previously, the USDA expected Pakistan to import 1.25 million bales during the 2004-05 marketing year, but it

lowered its estimate for Pakistani imports to only 1 million bales. Pakistan produced only 7.8 million bales in each of the past two years.

Chinese output was revised downwards by 500,000 bales, to 29 million bales, still a record crop by far.

There has been talk that Chinese demand will increase while China comes under constant pressure to abide by WTO guidelines, but in the near term it is unclear whether such pressure will have a noticeable impact. In the meantime, the US continues to squabble with China about compliance. On January 10, US trade representatives officially criticized China's decision to impose a tax on Chinese textile exporters. China is not likely to do anything that does not serve its best interests. Any actions it does take will be to pacify international trade cops.

The one bright spot in the market is that US exports are moving fairly well, and even a tad better than expected. As of this past week's weekly sales report, US exporters have sold 8.878 million bales of cotton, compared with 9.153 million bales at this time last year. While this is about 4% slower than last year's pace, the USDA estimate for annual exports is looking for a dropoff of about 8% from last year. To reflect the steady pace of sales, the USDA raised its US export fore-

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cast for 2004-05 by 200,000 bales in the January supply/demand situation report.

Still, there is nothing extraordinarily bullish about US exports when stacked up against the anticipated buildup in inventories that will result from the explosive growth we've seen in US and Asian output. Global ending stocks for 2004-05 are expected to grow to 47.12 million bales, or 45.12% of consumption, compared with 2003-04 ending stocks of 35.61

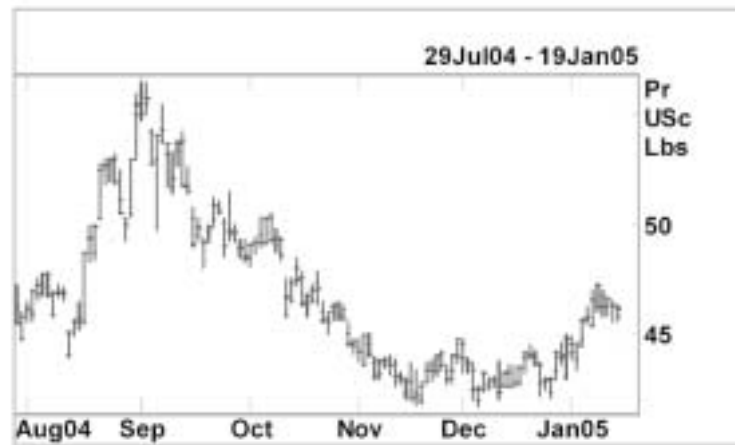
million bales, or 36.19% of consumption.

We remain bearish and will be looking for telltale signs of the end of the short-covering rally (perhaps not exclusively based on commitment-data because of the massive failure of its signals described above) to get back on the short side.

[Jan. 19, 2005]

**STRATEGY:** *Stay tuned.*

Chart 1 – March cotton



Courtesy Reuters

## SUGAR

### Indian imports are growing

Last month we focused on how open interest in sugar had grown to record levels. Bulls were justifiably on edge, anticipating a liquidation by commodity funds as prices continued to fall short of the 9.3¢-per-pound highs set way back in early October.

While the fundamentals are generally believed to be bullish, there didn't seem to be any fresh inputs to drive the market through the top of the range. With very few updates to the global supply/demand balance crossing the wires, the stalemate persists.

The last round of estimates came in between a small deficit and a balanced market. The only bit of concrete news we've seen recently is a 400,000-tonne upward revision to the EU 25 crop, to 19.1 million tonnes.

Crop forecasts for the 2004-05 Indian crop are now below the 12-million-tonne mark, with one estimate seen as low as 11.5 million tonnes. This compares with 12 million tonnes we cited last month and 13.5 and 20 million tonnes for 2003-04 and 2002-03 respectively.

On January 6, Reuters carried a story quoting an unnamed senior government official who said India would not allow any imports of white sugar. The following day Reuters carried a story quoting the Indian food minister

who indicated the exact opposite of the previous day's statement made by the anonymous official. Shortages are no longer a distant fear.

Domestic prices have risen by more than 40% over the past year, which has prompted the government to release 400,000 tonnes to the market. The move has quelled price pressure to some degree, but the market remains tight. While government officials were talking about imports for the entire marketing year reaching 1.5 to 2 million tonnes, we are obviously now looking at those figures becoming the floor rather than the ceiling.

On January 18 the Indian food minister acknowledged that 1.5 million tonnes of raw sugar have already been purchased, a good chunk of which has been shipped. He acknowledges that another 1 million tonnes may be required. One analyst said this week that India may require as much as 4 million tonnes.

Far less important, but symptomatic of the impact weather had on the broader region during the 2004-05 growing season, Pakistan grew only 3.3 million tonnes of sugar, compared with 4 million tonnes last year. This has forced Pakistan to raise its import quota by 50,000 tonnes, to 250,000 tonnes.

It is clear to us that the market has underestimated Indian needs and that this has yet to be reflected in estimates for the global supply/demand balance.

A closer look at the composition of the open interest reveals that the market may be far less vulnerable to a liquidation phase than the street believes. The commodity fund net-long position peaked in mid-October at 68,074 contracts and coincided with the 9.3¢-per-pound high. But the series of price shakeouts we've seen since then have obviously changed the mood of the speculative community, because the net-long position has contracted to 34,560 contracts. So even while open interest has continued to grow, the commercial and speculative groups have been swapping sentiments. Commercial traders actually decreased their

net-short exposure by 35,000 contracts during the 0.75¢-per pound selloff that took place between January 4 and January 10.

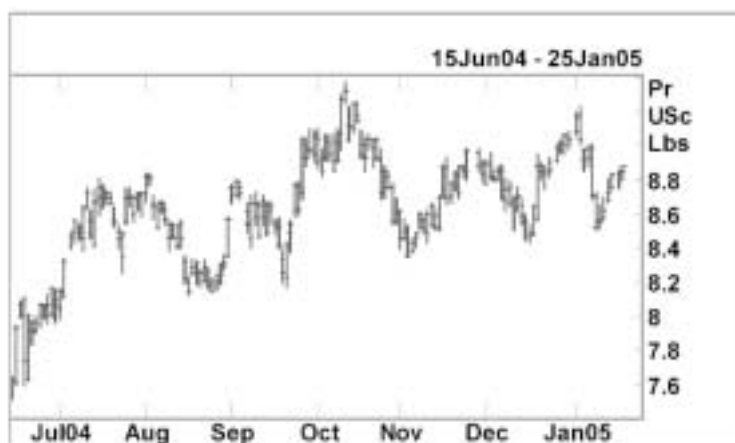
In addition, in regressing a bit further into technical analysis, we find that while the market has been stuck in an 8¢- to 9¢-per pound range over the past year, each dip has created a series of higher-lows, which in English would translate to mean that commercial traders (read India) are willing to buy and thereby support the market at increasingly higher levels (Chart 2).

We reiterate our bullish view on this market.

[Jan. 20, 2005]

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

Chart 2 – March sugar



Courtesy Reuters

## COCOA

### For now, drifting aimlessly

On January 4 the news wires ran a little-noticed story about an Ivorian rebel group that set up barricades intended to seal roads leading to the port at San Pedro. Some export activity was affected, but for the most part, the incident drew little interest from the press or market participants. Prices continued their decline, shedding an additional \$60 per pound before finding some support at the \$1,460-per-tonne level.

The dismal pace of Ivorian port arrivals is probably loosely connected to such incidents. Some analysts blame slow arrivals on the low guaranteed farmgate price, which has prompted an increasing number of farmers to attempt to sell their beans across the border in Ghana where the guaranteed farmgate price is 25% higher than in the Ivory Coast.

The gap between this year's arrivals and last year's has narrowed a bit from the previous reporting period, but remains substantial. On January 17 arrivals at the two ports totaled 693,313 tonnes, down 11.8% from the same time last year. This is a slight improvement from the January 7 figures,

which showed arrivals running 13.6% behind last year's pace.

There have not been any recent forecasts for the 2004-05 global production/consumption balance. Estimates we saw in December were looking for a deficit, but it is almost impossible to have anything close to an accurate estimate this early when so many variables are still unknown. The West African crops still have a way to go, and the demand side is unclear as well.

Speaking of the demand side, ED&F Man's most recent report back in November estimated that global grindings would fall from a 7.1% rate of growth in 2003-04 to a meager 1% increase in 2004-05. Thus far, its prediction does not look far off the mark. The German grind for the fourth quarter of 2004 was up 2.7%, but the Pan European grind for the same period was down just under 1%. The US grind will be released later this month.

Butter ratios had begun to decline in the post-holiday season after reaching historical highs of 3.5 times the London spot

bean price. It seemed that they were headed back to 2, which would have quashed any notions bulls had about strong demand. But the ratio has since stabilized and has been quoted in Germany at about 2.9, which still indicates fairly good demand. Powder and cake still remain in ample supply, and dealers are reluctant to offer butter without the other two products unless the butter price is artificially high. After the holiday rush, when buyers were less pressured, they backed off butter purchases. With butter ratios firming up again, we are led to believe that demand for butter is strong enough for buyers to begin bidding up the cost of the total package once again.

All of these observations do not direct us to anything very conclusive, but they do provide us with a number of indicators to look at as an aid in determining direction as the marketing year wears on.

It is clear that Ivorian production is vulnerable. The civil unrest has had temporary implications for the movement of beans from the bush, but the beans are getting through. Market participants are not very concerned, as evidenced by the lack of interest in the January 4 incident cited above. If the pace of port arrivals does not pick up, it may simply mean that the crop is smaller than last year. Smuggling into Ghana is a

given, but 150,000 tonnes (the estimate of 2003-04 smuggling) should already be in the market. Can that number increase substantially? Perhaps.

We retain a slight bullish bias. Unless the Ivorian situation changes dramatically, we will almost certainly not reach last year's output level. ED&F Man's demand forecast is very conservative. Regardless of sub-product demand, demand for the primary product, butter, is strong. We continue to believe that this will eventually show up in grinding data.

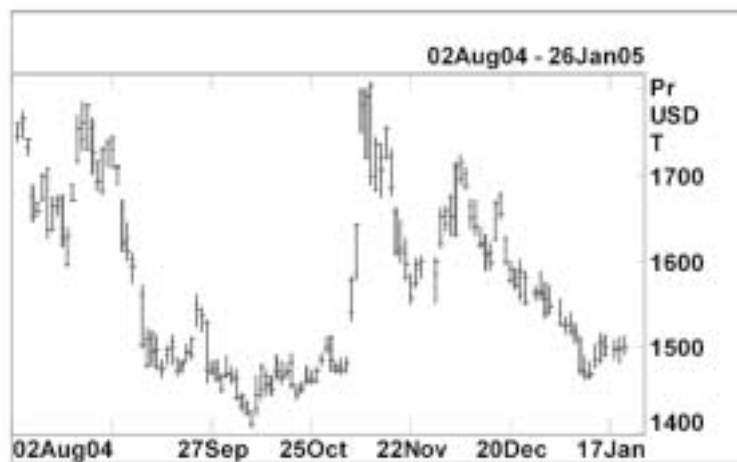
Commodity funds were carrying a substantial net-long position. When they began to liquidate, it seemed that prices would take a break down to the \$1,400-per-tonne support level to complete the liquidation. But the funds managed to reduce the net-long exposure over the past 3 weeks, moving from a position of over 20,000 contracts, to just over 4,000 contracts as of the most recent Commitment of Traders report.

We continue to observe from the sidelines for now.

[Jan. 20, 2005]

**CURRENT STRATEGY:** Remain long May cocoa as per Flash Update of Jan. 25. Maintain stops at 1450, close only.

Chart 3 – March cocoa



Courtesy Reuters

## COPPER

### The bull is aging

On January 3, the first business day of 2005, the copper market celebrated the New Year with a new contract high. March copper settled at \$1.4735 per pound. The party was short lived, though. During the following trading session, prices plummeted 13¢ per pound, or a whopping 9%. The item that triggered the plunge was news the Chinese export tariffs on copper and aluminum went into effect. The going theory: Lower exports of semi-finished metal products would in turn reduce Chinese import needs of unrefined metal.

Prices have now recovered the bulk of their losses. In fact, it took just that one trading session to absorb all the selling, and the market has rallied ever since. Does the bull market resume from here? Technically speaking, it would seem that the market experienced a one-day correction and continued forming higher lows on dips, a classic bull market counter-trend pattern (Chart 4).

In December we highlighted several issues, both on the supply and demand sides. We find that most developments are

bearish, save for one that lends a fair amount of confusion to our generally bearish case.

A significant divergence in the direction of the inversion at Comex and LME has emerged. In New York, the March/July spread has fallen from a peak of 12¢ per pound in October to its current 5.5¢ per pound (Chart 5), even with the market just shy of contract highs. In London, however, during the same period, the market has inverted from \$60 per tonne to its current \$173 per tonne (Chart 6).

We cannot offer a reasonable explanation for the difference. We've read that the tightness in London is not the result of an isolated, short-term problem, but rather representative of the general environment of tight supplies. It is quite possible, though, to have a localized shortage in London, while supplies are ample in New York. While there may be a time lag in moving the supplies around, ultimately the supplies are mobile.

Aside from this, most indicators are moderately bearish. The most recent International Copper Study Group (ICSG) data show a small pullback in the global deficit for the January-to-October period, to 757,000 tonnes, down from the previous month's 777,000 tonnes.

On January 27, Phelps Dodge Corp. said that it expects global copper demand to maintain its pattern of 2% to 3% growth in the US and Europe and much higher in Asia, which would add up to a global growth rate of 4% to 5%. Developments on the supply side, however, mitigate this potentially biased opinion.

Chilean copper production had another stellar month with output growing at 13.5%. Average monthly output for the second half of 2004 grew 14.05%, and about 10% for the year. The Chilean government's estimate for 2005 is calling for output growth of only 3.5%. Given the recent torrid pace of production, this forecast seems to be on the conservative side by

a wide margin.

Commodity funds still own a large net-long position of 20,000 contracts. The massive, post-New Year's slide did wipe out some spec longs, but this past week's data show that funds began to rebuild their long position immediately following the large one-day decline. This may be an indication that the market's strength is the result of speculative interest rather than a continuation of solidly bullish supply/demand fundamentals.

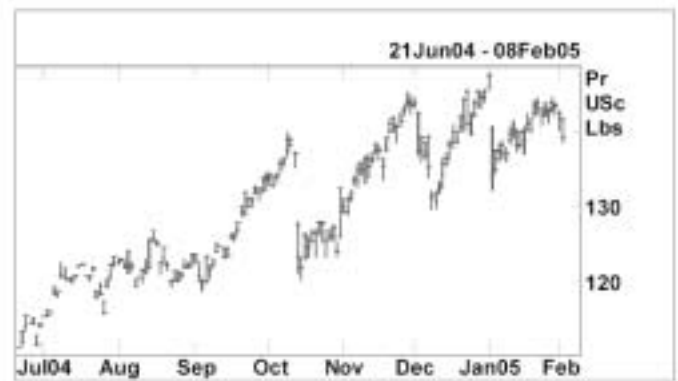
Warehouse stocks are still very low, but have stopped falling.

In conclusion, we believe that these prices have enticed a flow of production that will overwhelm growth in demand. We'd be more comfortable with a short position if the backwardation in London were to ease. Our finger is on the trigger.

[Feb. 3, 2005]

**STRATEGY:** *Stay tuned.*

Chart 4 – March copper



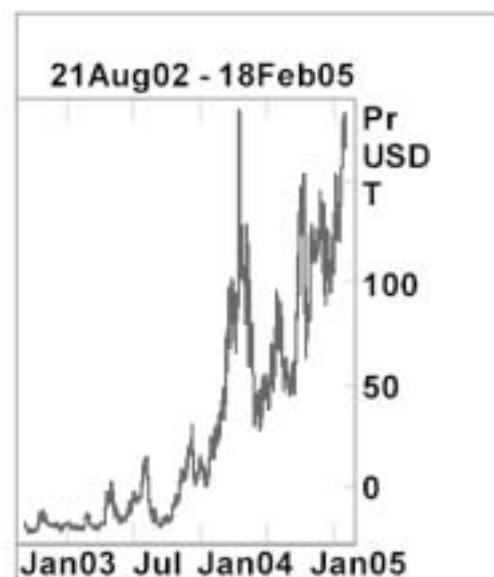
Courtesy Reuters

Chart 5 – March/July Comex



Courtesy Reuters

Chart 6 – LME cash/3months



Courtesy Reuters

## HOTLINE UPDATE

**Flash Update – Wednesday, January 5, 2005:**

Good afternoon for Wednesday, January 5, 12:10 pm. This is a Flash Update. We have covered our short March cotton position at 45.25

**Flash Update – Friday, January 7, 2005:**

Good morning for Friday, January 7, 9:20 am. This is a Flash Update. We have liquidated our long March cocoa position at 1505.

**Friday, January 7, 2005:**

Good afternoon for Friday, January 7, 4:40 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On January 5, we covered our short March cotton position at 45.25. On January 7, we liquidated our long March cocoa position at 1505. We are currently holding no positions.

**Flash Update – Wednesday, January 12, 2005:**

Good morning for Wednesday, January 12, 9:00 am. This is a Flash Update. We have sold short March Canadian dollar at 82.65, placing our initial stop at 83.68, close only. We have also purchased November soybeans at 562.25, placing our initial stop at 542.25, close only.

**Flash Update – Wednesday, January 12, 2005:**

Good morning for Wednesday, January 12, 11:15 am. This is a Flash Update. We have covered our short March Canadian dollar position at 83.68. We repeat our Flash Update of earlier today where we purchased November soybeans at 562.25, placing our initial stop at 542.25, close only.

**Flash Update – Friday, January 14, 2005:**

Good afternoon for Friday, January 14, 2 pm. This is a Flash Update. We have liquidated our long November soybean position at 542.25.

**Friday, January 14, 2005:**

Good afternoon for Friday, January 14, 5:05 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On January 12, we sold short March Canadian dollar at 82.65, covered our short March Canadian dollar position at 83.68, and purchased November soybeans at 562.25. On January 14, we liquidated our long November soybean position at 542.25. We are currently holding no positions.

**Friday, January 21, 2005:**

Good afternoon for Friday, January 21, 4:25 pm. There were no transactions this week, and we are currently holding no positions.

**Flash Update – Tuesday, January 25, 2005:**

Good morning for Tuesday, January 25 10:20 am. This is a Flash Update. We have purchased May cocoa at 1530, placing our initial stop at 1450, close only.

**Friday, January 28, 2005:**

Good afternoon for Friday, January 28, 4:25 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On January 25, we purchased May cocoa at 1530. We are currently long May cocoa at 1530, with our initial stop at 1450. All stops are close only.

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