

# FRIEDBERG'S

## FOCUS ON FUTURES

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## West African cocoa crop estimates droop

Ivory Coast cocoa arrivals for the 2005-06 marketing year are running significantly ahead of last year's pace. It comes as no great surprise, because weather was favorable in the early part of the growing season, which got the crop off to a strong start. Crop size was expected to return to normal after an off year in 2004-05. In fact, if the current pace is maintained throughout the main- and mid-crop seasons, we may very well be looking at a record crop. As of December 19, arrivals at the two Ivorian ports totaled 560,000 tonnes, compared with 390,000 tonnes in mid-December 2004 and 410,000 tonnes in 2003. But looking at the year-to-date arrival figure in isolation may be misleading.

There is some doubt about whether arrivals can indeed continue at these levels. Precipitation is still crucial, and it's been fairly dry. Seven of the nine principal cocoa areas have reported below-average rain over the past week or so. We know from experience, though, that the accuracy of weather reports in the region is suspect. To illustrate: The lack of rain has been the prevailing weather story for the Ivory Coast, but an item has surfaced on the news wires about exceptionally heavy rains in the western cocoa belt, which were allegedly strong enough to rip the protective flowers from trees and expose the pods to disease and rot.

In addition to the confusion over weather, one press report claimed that poorly tended plantations were observed during an independent tour, suggesting the improbability of maintaining the current port-arrival pace.

All in all, it does seem that a huge crop is no longer a given with the potential for a slump in the tail of the main crop and the entire mid-crop.

While climatic conditions are inconclusive, arrival data have proven to be a fairly accurate method of determining crop size in the Ivory Coast, so we'll know soon enough if poor weather will spoil predictions for a bumper crop. Although we're heads above the end-of-December level of the past couple years, there have been reports that the flow of

beans from plantation to port has slowed. This has not shown up in the official data to date – arrivals jumped about 40,000 tonnes over the past week – but it certainly gives us a clear indicator that we can watch.

Crops of neighboring West African countries Ghana and Nigeria will also be affected by the same weather patterns, and indeed, analysts have already issued warnings that early estimates for the crops of both countries were optimistic.

Even before this new supply-side issue emerged, cocoa analyst Jonathan Parkman was forecasting a production/consumption deficit of 114,000 tonnes for 2005-06. He was looking for an increase in global production of 13,000 tonnes, but a much larger 103,000-tonne jump in consumption.

Butter ratios have maintained their strength for the most part. In Asia the ratio has slipped a bit to about 2.7 times the London spot price for beans, but in Europe the ratio is still hovering at 3. On average, the price of butter remains close to historical highs, supporting the notion that demand is solid.

Commodity funds have piled onto the long side, moving from a short position as recently as several weeks ago to a 16,000 contract net long position. Of course, this can be quite constructive for bulls who wish to ride with the funds, but

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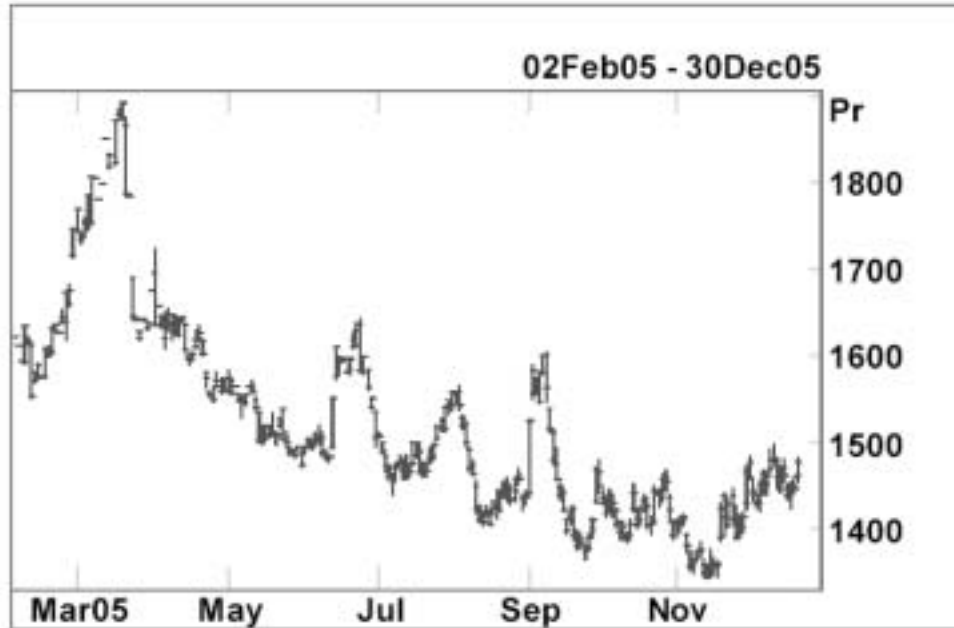
forces us to scrutinize how much of the recent rally is related to supply/demand fundamentals, which ultimately will determine if the rally is sustainable. Thus far, the build in the open interest has been modest and has moved with the market,

which we consider constructive.

Our long-held – but at times dormant – bullishness has resurfaced, and we advise being long cocoa.

[December 23, 2005]

Chart 1 – March cocoa



Courtesy Reuters

## COTTON

### A record US crop, but record exports too

Based on the performance of the 2005-06 US cotton crop alone – which happens to be the primary focus of traders until the harvest is complete – one could be lulled into believing that the cotton market is amply supplied. With 14.18 million acres planted, acreage was substantially higher than the two previous seasons (13.48 and 13.66 million acres respectively), but nobody expected the extraordinary 2004-05 yields of 855 pounds per acre (730 in 2003-04) to be repeated. Then it seemed that Katrina would do some damage. But as the harvest began, it became clear that the crops were in fine shape.

The December USDA supply/demand situation report estimated the average yield at 832 pounds per acre, up substantially from the November estimate of 813. The crop is now estimated at 23.70 million bales, which would exceed 2004-05 output of 23.25 million bales. Quite a feat.

Despite the unexpectedly good showing for the US crop and large global inventories carried over from 2004-05, the

global balance sheet will tighten this year because of increased demand and a smaller crop in China.

Chinese output is estimated at 24.5 million bales. For the moment, the huge 29-million-bale crop grown in 2004-05 was a flash in the pan, and we're back to average-sized crops. Demand in China, however, is forecast to grow from 38.5 million bales in 2004-05 to 43 million bales. The USDA estimates Chinese imports at 16.5 million bales, up 10 million bales from 2004-05.

Statistics for US exports so far this marketing year reflect the surge in global demand. As of the most recent export commitment report, US exporters have contracted to sell close to 10 million bales, compared with only 8 million bales at this time last year. Shipments are well ahead of last year's pace as well. At this rate, the USDA's 16.4-million-bale target for the year (14.4 million bales in 2004-05) is well within reach.

A closer look at the US data shows that China has been an excellent customer. Chinese purchases stand at 4.6 million bales (includes about 1 million unshipped bales from 2004-05), compared with only 750,000 bales at this time last year and 3.1 million bales shipped all of last year.

Global ending stocks are estimated at 50.92 million bales, or 44% of consumption, somewhat tighter than last year's 47%. While this may still seem rather burdensome, we are headed towards inventory levels that have triggered periods of substantially higher prices in recent history. In 2003 prices ran up to 85¢ per pound against a backdrop of carry-over stocks of 39% in 2002-03 and 36% in 2003-04. We're certainly not there now, but if US sales continue to surprise to the upside, we can get there in a hurry.

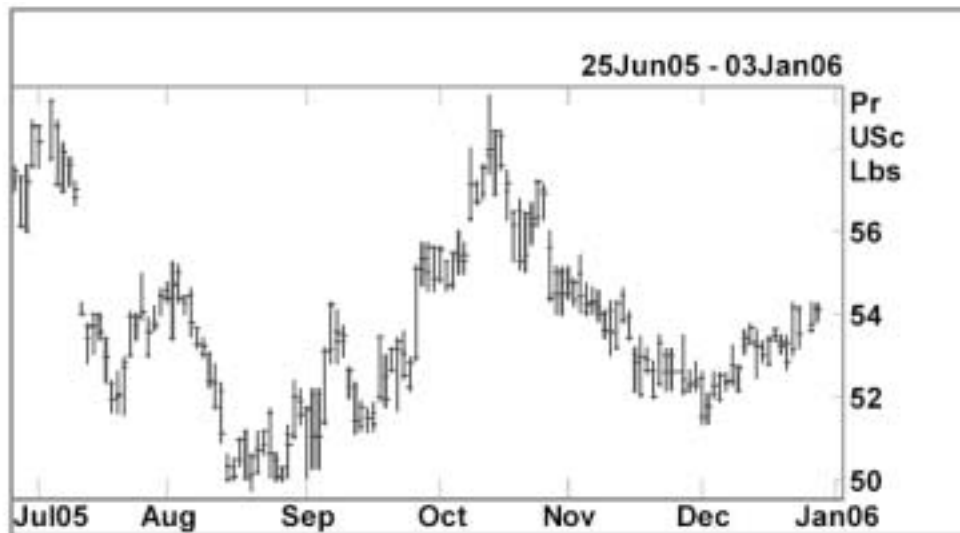
An important long-term issue that is not even close to

being pertinent at the moment, but that will dominate the cotton market down the road, is the progress of the WTO pressure on the US to phase out subsidy programs. Although years away, implemented reforms could alter the cotton industry radically for the world's largest exporter. Inefficiently produced cotton, which relies on US government handouts to achieve profitability, will be eliminated.

In the short term, we believe the market became oversold while the street focused on the supply side and underestimated demand. Commodity funds are caught short and are scrambling to cover. As of last week's Commitment of Traders report, funds were net-short about 17,000 contracts. The developing fundamentals do not support that stand, and we advise trading this market from the long side.

[December 28, 2005]

Chart 2 – March cotton



Courtesy Reuters

## COPPER

### Can this bull run indefinitely?

Our bearishness in copper has definitely been premature. Chinese consumption remains very strong, and – based on recently released economic statistics – there is little reason to assume that demand for copper will let up any time soon.

The surprising slowdown in Chilean output created a *bona fide* tightness in the market that depleted warehouse inventories in London, New York, and Shanghai. The short position instated by the now famous (infamous?) trader work-

ing for the Chinese government exacerbated the situation. The street knows that the position has to be covered eventually, and in market parlance “the maximum pain possible” will be inflicted.

While there is now little doubt the bull market in copper was rooted in bullish supply/demand fundamentals, we maintain that the *magnitude* of the run has brought the market to unsustainable price levels. The breakeven price for mining

companies is \$1 per pound or more below current prices, and it is inconceivable that production increases will not surface sooner or later. Most of the world's copper is produced in either completely stable or relatively stable political environments, so there is no need for disaster premiums the way there is for some other commodities we trade.

There are several new developments. This month's International Copper Study Group (ICSG) report represented a further setback for bears. Last month the global production/consumption deficit shrank to a multi-month low of 114,000 tonnes – the closest we've come to a balanced market since the June ICSG report showed a small surplus for the first quarter of this year. But the new figures released on December 29, which cover the period between January and September, show that the deficit jumped back up to 190,000 tonnes, just shy of the 235,000 peak recorded in October.

These numbers do seem to be a perfect fit with the new highs in price, but we should bear in mind that the ICSG data are always three months behind. Some of the more up-to-date indicators are not as consistent with the market action, which has pushed copper prices to over \$2 per pound.

First, warehouse stocks at the LME continue to grow. Although inventory levels remain light years from where they

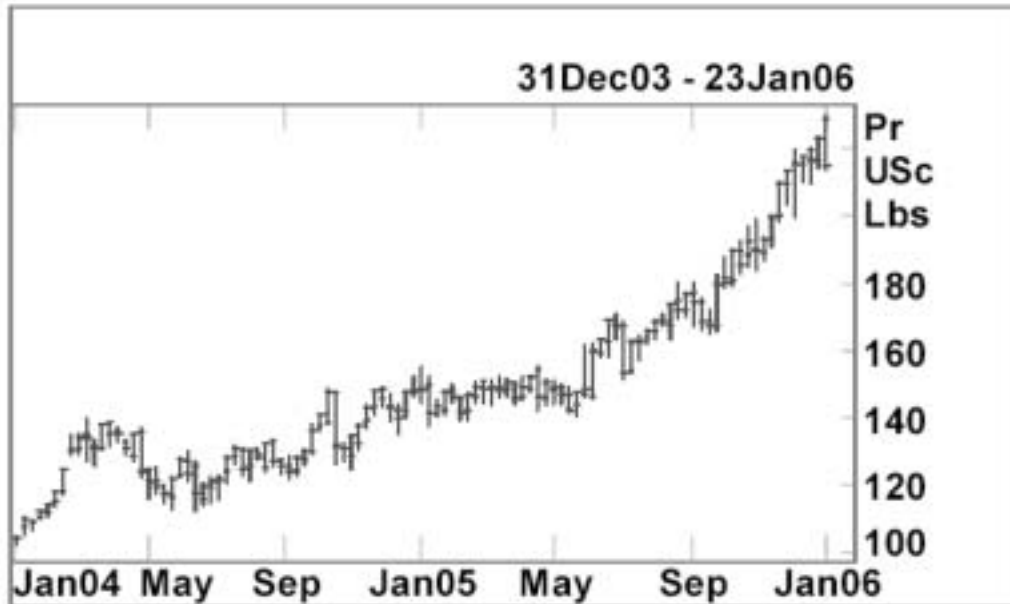
were several years ago, they've returned to and surpassed the level at which the inventory build failed in September. LME stocks now stand just below 90,000 tonnes after touching a low of 25,000 tonnes in July. Volatility in warehouse stock movements also provides a gauge with which to monitor the market on a daily basis. We believe, for example, that it will be quite significant if LME stocks move to over 100,000 tonnes.

The November output figures for Chile were released this week showing an ever-so-small year-over-year gain of 0.6%. Insignificant as this may seem, it is the first monthly increase in output since August, and again, a useful indicator with timely information.

While respecting the near-impossibility of timing the end of this monstrous bull run, we continue to recommend being short the March/May COMEX (Chart 4). The concept has not yielded any profits, but at the same time has not grown any wider, even as the market surged to new highs. So although the market remains in backwardation, we conclude that the market has not become any tighter since November when the spread peaked.

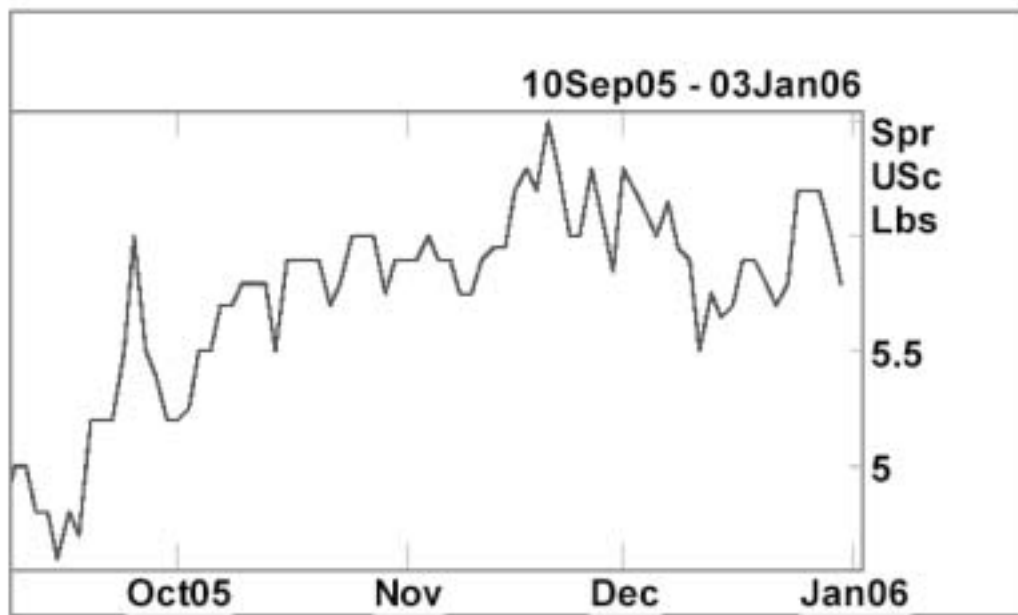
Maintain short March/long May spreads with a stop at a close above a 6.5¢-per-pound spread. *[December 30, 2005]*

Chart 3 – Weekly copper



*Courtesy Reuters*

Chart 4 – March/May copper spread



*Courtesy Reuters*

## WHEAT

### Recovery in global production loses momentum

Judging by raw data alone, there isn't very much with which to build a bullish case for wheat. Although wheat acreage in the US – still the world's largest exporter – is in perpetual decline, the slack has been picked up by Canada, Australia, the EU, and to a lesser degree Argentina this year because of its sub par 2005-06 crop. The EU also had a much smaller crop than in the two previous seasons, but its exports seem to be on track for a normal year.

The USDA increased its estimate for global output in its December supply/demand situation report by 5 million tonnes, to 615.33 million tonnes, while hiking its forecast for consumption by only 2 million tonnes to 622.08 million tonnes in the November estimates. The estimate for global ending stocks rose to 143.35 million tonnes, or 23.04% of consumption, up from 22.5% last month, but still below 2004-05 carryover stocks of 24.66% of consumption.

After many years of falling global production, 2004-05 saw a huge leap in output (13%). The question, of course, is whether it was the beginning of a trend. Even after this month's upward revision, 2005-06 global output will be

down 11.3 million tonnes, or 1.8% from last year. Production is still dramatically above the average of the five years that preceded last year's record output, but there will be a production/consumption deficit of seven million tonnes. Although the level of output was maintained, it was not enough to prevent a return to the stock-drawdown days.

Market action has been friendly, with a nice rally off the bottom after the market threatened to break the \$3 per bushel level earlier this month. Basic technical analysis will dismiss this rally as a correction in a bear market, with the peak of the rally doing nothing more than touching the downtrend line and forming yet another in a series of declining tops. Commodity funds were heavily short, so a short-covering rally would be perfectly consistent with this pattern.

There are a number of variables, though, that could easily change the inconclusive supply/demand fundamentals to the bullish side and negate any technical analysis.

The balance between Indian production and consumption is precariously close, as it has been for years now. The only difference is that it has been depleting its inventories.

According to the USDA, carryover stocks have dwindled in recent years and now represent only 5% of consumption, compared with 10% at the end of the 2003-04 season. A government agency declared recently that India would not have to turn to the import market to meet its needs. Private market analysts, however, see things differently. India's wheat harvest does not begin until the spring, and much depends on how the crop fares.

The USDA is forecasting that US exports for 2005-06 will decline from last year by 1.7 million tonnes, to 27.22 million tonnes. But as we illustrated back in October, export commitments are on pace for a better performance than that. And the gap has narrowed since then. At that time, sales were 8.3%

behind 2004-05; now they are only 2% behind. It is early in the marketing year, and things can go either way.

On January 12 we get a look at a more advanced estimate of US winter wheat acreage. Based on planting activity and climatic conditions since the first USDA estimate of 40.3 million acres, private analysts have raised the USDA's first acreage estimate. In mid-December Informa Economics released its estimate at 41.8 million acres.

Wheat prices remain relatively inexpensive in historical terms. We remain sidelined for the moment, but our sentiments are friendly, and long-term players should be looking to establish a long position on setbacks.

[December 28, 2005]

Chart 5 – March wheat



Courtesy Reuters

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