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Corn: high prices have yet to discourage foreign purchasers

After taking a three-week breather, the bull market in corn seems to be back on track, with March corn climbing back to just shy of the 393.5 per bushel high set on November 27. A number of issues slowed the process while market participants mulled over their potential impact.

Over the past several weeks, reports began to surface that the Chinese government was considering measures that would limit incentives that had been extended to bio-fuel processors to encourage production. Domestic corn prices in China rose about 20% over the past few months, which has caused concern among authorities that food supplies are vulnerable.

Official statistics show that annual ethanol production stands at 1.3 million tonnes, but it is widely believed to be more than three times that figure. The initial reaction was that this would translate into lower demand for corn and ease a budding tightness in China, but the development merely served to highlight just how tight the corn market really is. There are indications that Chinese exporters will not even be able to meet commitments for the four million tonnes they contracted for export for this marketing year.

Chinese corn production has by and large kept pace with the increase in domestic consumption, growing from 115 million tonnes in 2003-04 to this year's 143 million tonnes. The ethanol industry, however, was almost non-existent until 2004 and has grown rapidly. One Chinese think tank estimates that in 2005-06, industrial uses for corn outside the feed market grew by 25%. This would mean that about 15% of the Chinese corn crop is used for industrial purposes (mostly ethanol), compared with 30% in the US, which is quite an achievement considering how young the whole industry is in China.

Although the estimates are very rough, because as illustrated, we don't really know how much ethanol is being produced, there is a strong sense that the very same problem that ignited this bull market in the US is repeating itself in China. In the short term, the Chinese may very well have to turn to the export market, and in the longer term acreage will have to be expanded.

Speaking of acreage, the next important matter that will determine price direction is US acreage. There is no doubt that US plantings will jump this coming spring.

There has been much discussion regarding whether Congress will facilitate the release of acres from the Conservation Reserve Program (CRP). Even if that were to happen, the impact would be minimal, because many of the acres eligible for release are owned by farmers who either have little interest in farming those acres or lack the necessary equipment. Where the motivation and means do exist, it would take at least a couple of seasons until the acres in question could produce yields that would make a difference to the overall picture.

US farmers will, however, shift a massive amount of acres from soy to corn for the 2007-08 season to be planted this spring. Although, soybean prices have tagged along for the ride, corn prices have still risen dramatically against soybean prices (Chart 1). Where the choice exists, farmers will opt to grow corn and lock in very attractive prices for their 2007-08 crops. Even in new crop months, where corn is at a discount to the spot and soybeans are at full carry, the historical ratio still favors planting corn (Chart 2).

On December 14, highly regarded forecaster Informa Economics raised its estimate for US corn acreage to 85.9

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Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.ca).

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million acres, from its 84.9-million-acre November estimate. This would represent a 9.3% jump from 2006-07 plantings of 78.6 million acres. Even with current consumption patterns, an increase in output of that magnitude could very well calm the market, and prices could start pulling back.

Another potentially bearish factor is South America. The December USDA supply/demand situation report raised estimates for the corn crops that will be harvested over the coming months. The estimate for Brazilian output was increased to 42 million tonnes from 41 million tonnes while Argentinean production was bumped up to 19 million tonnes from 17.5 million tonnes. These increases could serve to tide the market over to some degree until next autumn, when the new US crop will become available.

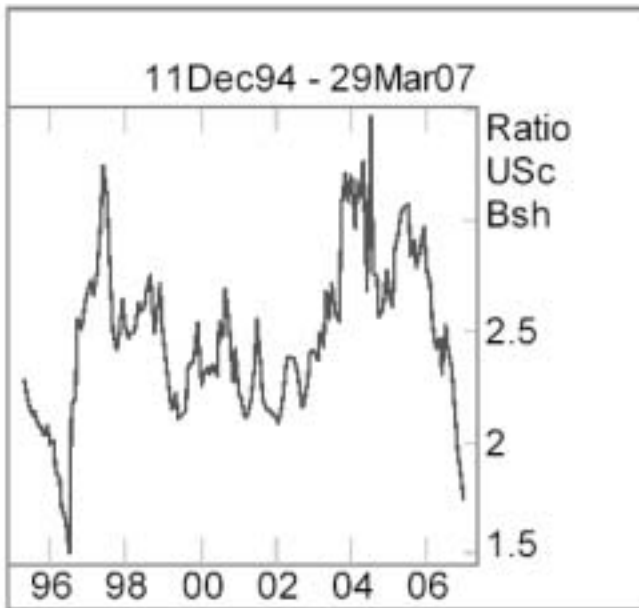
Even after these production increases are factored into the balance sheet, the estimate for 2006-07 global inventories remain very low at 19.4% of consumption, compared with 26.4% at the end of 2005-06.

Although the advent of ethanol usage has changed the

complexion of the corn market and is likely to continue to underpin the market, US exports have been extraordinary, and the foreign buyers are not ethanol processors. Commitments as of the most recent sales report stand at 28.6 million tonnes, up from 21.1 million tonnes last year at this time. The USDA forecast for annual exports is for an increase of a scant 2.5%, far shy of the jump indicated by the commitment tally. Obviously, the USDA is basing its estimate on the historical propensity of foreign buyers to balk at prices that have risen as much as corn prices have.

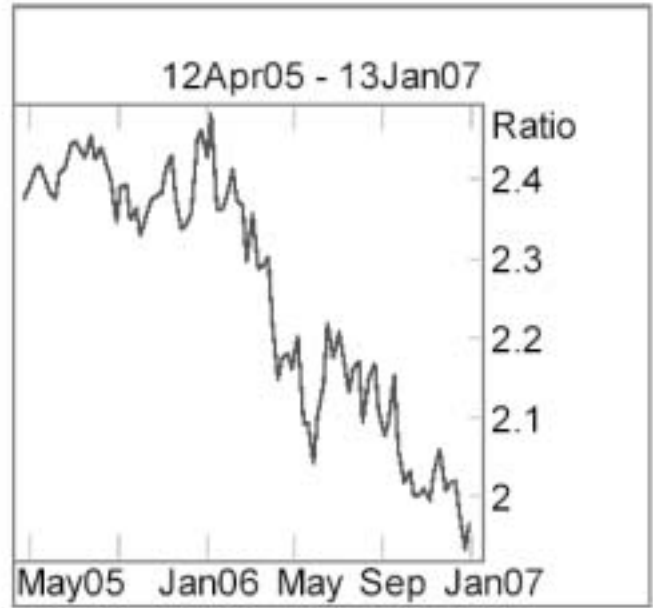
In summary, in the short term, as bulls we do not fear the extra few million tonnes that South American producers will have available. It is not enough to alleviate the tightness, and it's already built into the market. We do, however, consider the potential for expanded acreage in South America a threat one year from now. Similarly, the US will undoubtedly harvest a much larger crop in September 2007. Until then, we expect prices to move significantly higher. Remain long old-crop months. *[December 27, 2006]*

Chart 1 – Monthly soybean/corn ratio



Courtesy Reuters

Chart 2 – New crop soybeans/corn ratio



Courtesy Reuters

SOYBEANS

Is the rally warranted?

A superficial glance at a chart of March soybeans shows a strong advance, a high level consolidation, and perhaps a market that is ready for a breakout above its recent highs (Chart 3). The pretty picture may be somewhat deceptive. For a number of reasons – some logical and some not – the bull run in soybeans can be attributed to spillover from the fundamentals-based bull markets in corn and wheat.

To illustrate, consider that since January, soybean prices are up only 20%, whereas corn and wheat have skyrocketed 100% and 80%, respectively. On the one hand, speculators – of the bargain-hunter variety – are attracted by the “one that hasn’t moved yet.” On the other, it is well understood that soy acreage will be compromised wherever possible for corn or wheat acres, which can potentially turn

the tables and create tightness in the soybean market.

In fact, that is exactly what is happening. Early forecasts for US 2007-08 plantings, which will start in just a few months, show a dramatic shift from last season. On December 14 Informa Economics estimated that soy acreage would fall to 70.34 million acres, down from 75.6 million acres in 2006-07, with the beneficiaries being corn and winter wheat (see the December 28 *Focus on Futures*, "Corn: high prices have yet to discourage foreign purchasers").

Before next fall's US crop becomes an issue, however, the market's focus will turn to South American crops, which will enter harvest season in just a couple of months, and which at the moment are looking fairly healthy. Even though Brazilian soy area of 20.7 million hectares is 7% smaller than the 2005-06 area, early forecasts are looking for a larger crop of 56 million tonnes, compared with 55 million tonnes last season.

Brazilian soybean crops have been plagued by drought over the past two seasons. For the 2004-05 and 2005-06 crops, early-season output estimates have assumed optimum conditions, but the crops have disappointed and have been as much as 20% smaller than the original forecasts. To date, it has not been proven that Brazil can achieve yields anywhere near the estimates that are calculated on acreage alone. Although weather has been friendly in the early going, if the pattern of the past two seasons repeats itself, bulls will have nothing to fear from Brazil.

The Argentinean situation, however, is a completely different story. Planted area is estimated at 16 million hectares, 6% above last year. The December USDA supply/demand situation report raised the estimate for Argentinean output to a record 42 million tonnes, up from 40.5 million tonnes last season.

Consequently, if all goes well in South America and the weather cooperates as crops mature and are harvested, reality could set in, as soybeans once again trade on their own fundamentals.

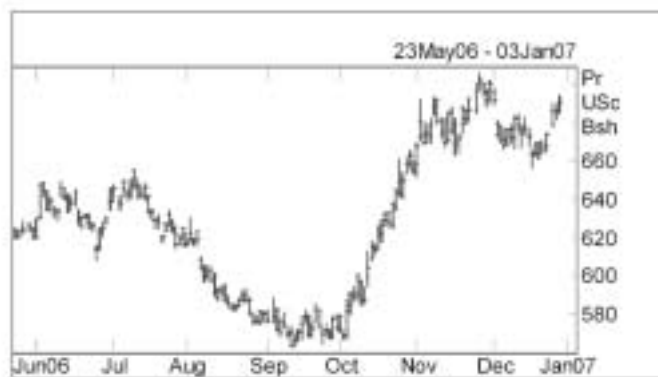
To present a completely balanced picture, we should take into account that demand has been very strong. The

USDA estimate for US exports for 2006-07 has been inching up all season and is now 31.16 million tonnes, up sharply from last year's final sales of 25.78 million tonnes. Export-inspection data, which monitor completed sales that are being shipped, show that demand is running ahead of the USDA's estimate for the season. However, commitment data are far out ahead, with contracted sales 36% larger than last year at this time. Of course, commitments can be canceled, but it is at the very least a strong indication that foreigners are not being discouraged by high prices.

Still, the record US crop harvested this past fall and the anticipation of record crops in South America have pushed the estimate for 2006-07 global ending stocks to a burdensome 55.72 million tonnes, or 25% of consumption, up from 24% last year. We'd have to go back to 1985-86 to find such a high level of inventories. The range in recent years has been 17% to 22%.

Our September 29 recommendation to "stand aside" proved to be seriously frustrating to bulls who adhered to that advice, with \$1 per bushel left on the table. We nevertheless maintain that in the absence of any fresh bullish fundamentals, this market has limited upside, and we continue to advise the safety of the sidelines. *[December 29, 2006]*

Chart 3 – March soybeans



Courtesy Reuters

SUGAR

Some bullish news, but surplus persists

After plunging from 19¢-per-pound highs this past summer, sugar prices have been crawling along in a range bounded mostly by 11¢ and 12¢ per pound. Most recently, the market has been pushing up against the top of that range, making bears a bit nervous that the market is oversold.

There have been several bullish developments that halted the slide and caused prices to consolidate, but overall, we believe the market is amply supplied.

Australian agriculture has been hit heavily by uncooperative weather this year. Sugar plantations had too

much rain earlier in the growing season, and then the weather turned too dry as the crop matured. The damage to the sugar crop pales in comparison to the disaster experienced by the wheat crops, but was enough to see recent estimates drop to 4.65 million tonnes, down from earlier estimates of 4.95 million tonnes, and down from last year's output of 5.3 million tonnes. It may not seem like much, but Australia exports almost its entire crop to Asian countries, and any shortfall has a direct impact on world trade.

Slashed subsidies have had a fairly quick impact on the sugar market in the EU. Although exports are still estimated at 1.4 million tonnes for the 2006-07 marketing year, they are down from 8.6 million tonnes in 2005-06, and F.O. Licht expects the bloc to become a net importer down the road.

The Brazilian government has been feeling quite comfortable that it achieved its goal of quelling ethanol demand and has therefore begun to ratchet up the minimum ethanol/gasoline ratio that drivers are required to use in their cars. The ratio was raised back to 23% ethanol from the 20% ratio that was instituted in March, and is expected to be pushed up to 25% upon review early in the New Year. These moves take several million tonnes of sugar away from the food side of the balance sheet and are clearly a bullish factor. Specifically, there have been estimates that put the increase in Brazilian sugar-equivalent ethanol consumption for 2007 at 2.5 million tonnes.

Turning to India, in our last article on sugar (November 3), we quoted F.O. Licht's 2006-07 Indian estimate at 27 million tonnes, up from 21 million tonnes in 2005-06. It now seems that was a bit optimistic, and the fantastic surplus on the global balance sheets may have been overstated. Recent estimates have been for Indian production to come

in at between 24 and 25 million tonnes.

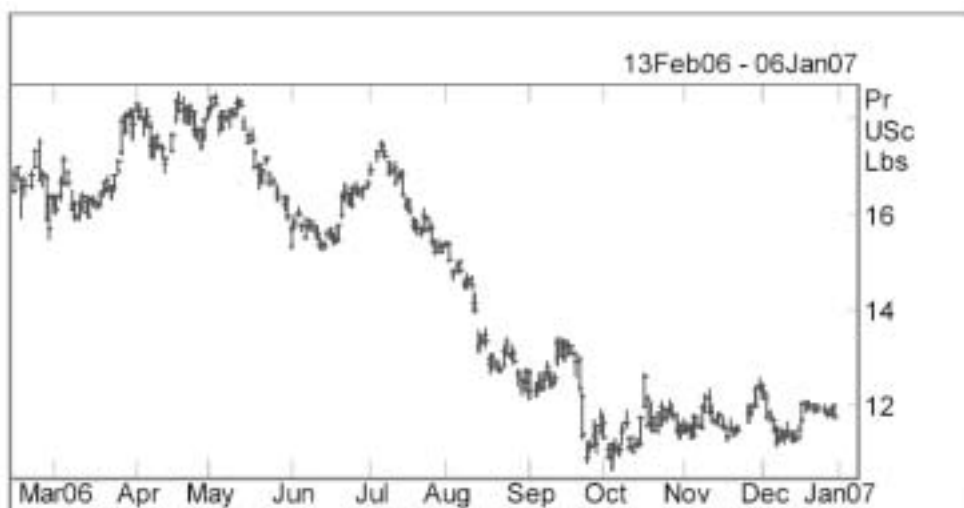
Regardless, even though domestic consumption is growing steadily in India – the current estimate is for a jump to 21 million tonnes from last year's 20.4 million tonnes – the country is still running a healthy surplus. The government has eased the export tariff infrastructure, and the country has turned from net importer to net exporter in the span of two seasons.

While we've presented the reasons for the market's recent strength, we should remember that all these factors are well known, and we are looking at an amply supplied market. We have swung from a global deficit of several million tonnes in 2005-06 to a forecasted global surplus of between five million and eight million tonnes.

There is a common belief in the commodity markets that any bio-fuel related commodity has a floor under it and will maintain a price premium as each individual market accommodates the newly created demand. The global corn balance sheet for 2006-07 is showing a substantial production/consumption deficit. But the sugar market has responded rapidly with massive increases in production.

Remain short with a 13¢-per-pound stop, basis the nearest contract. [December 29, 2006]

Chart 4 – March sugar



Courtesy Reuters

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Subscription Enquiries for
 Friedberg's Focus on Futures
 Suite 250, BCE Place
 181 Bay Street
 Toronto, Ontario, Canada
 M5J 2T3
 416-364-1171

All enquiries concerning trading accounts should be directed to:
In Canada
 Friedberg Mercantile Group Ltd.
 Suite 250, BCE Place
 181 Bay Street
 Toronto, Ontario M5J 2T3
 416-350-2903
 Attn: Sholom Sanik

For U.S. Persons
 Friedberg Mercantile Group, Inc.
 Suite 250, BCE Place
 181 Bay Street
 Toronto, Ontario, Canada M5J 2T3
 1-800-461-2700

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