

# FRIEDBERG'S

## FOCUS ON FUTURES

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## Cocoa output steady, but demand poised for growth

After rallying to multi-month highs, cocoa prices have retreated to consolidate their gains (Chart 1). The single most important factor for this market is the size of the Ivorian crop. According to official port arrival data, output is way ahead of last year's pace. As of December 31, arrivals stand at 783,000 tonnes, up from 622,000 tonnes at this time last year.

But as we discussed in the November 7 issue of *Focus on Futures*, we have to incorporate a different accounting system for this season, because the harvest began about a month early and is likely to end early as well. About 120,000 tonnes of the actual 2007-08 crop was counted as part of the 2006-07 crop because it arrived to port while the 2006-07 marketing season was still open.

To accurately measure the 2007-08 crop, we have to add the portion that was already counted in the previous marketing year to current arrivals, which would come to just over 900,000 tonnes. That compares with 830,000 tonnes at the end of January 2007. So we are indeed running ahead of last year's pace, by about 9%, but not nearly by as much as the 25% increase a cursory read of the headlines indicate.

Some evidence has emerged that the early start will not necessarily make it a longer than typical season. Weekly arrival totals peak in mid- to late-December. Arrivals over the past two weeks were below arrivals in the comparable period last year. The most recent figure was 62,000 tonnes, down from 64,700 tonnes last year. The previous week's tally was 70,000 tonnes, compared with 78,300 tonnes a year earlier. These numbers can be volatile, but they provide us with the ability to monitor a key barometer of supply that can be monitored. A strike at the various government agencies that deal with cocoa exports has prevented export registration, but it's only a few days old and would not have affected the data cited above.

Fourth-quarter grind data for Europe and the US will be released over the next few weeks. But the ratio of origin grindings to Western grindings continues to grow, which makes grinding statistics in the more traditional grinding

regions less useful as a proxy for global demand. A better-than-expected number in Europe and the US is more bullish than a worse-than-expected figure is bearish. Combined grinding capacity in the Ivory Coast, Ghana, Indonesia, Malaysia, and Brazil has reached about 1.5 million tonnes, close to half of all global grinding activity.

The demand indicators that we watch all show that consumption is strong. Asian butter ratios continue to inch up and are currently trading at 2.77 times the London spot price. In Europe, the ratio has jumped to 3.4, just a tad shy of all-time highs.

Furthermore, inter-market futures spreads have tightened. As Chart 2 illustrates, the spread did not collapse while the market was going through its counter-trend correction.

While the Ivorian crop will be larger than last year, there is nothing extraordinary about it and, at present, may not even live up to expectations. The other major producers are not contributing to the cause. Ghana is heading for average output of about 650,000. Indonesian production is looking to be sharply below last year's. Poor weather has plagued Indonesian plantations all season long, and as a result, output will be 510,000 tonnes, down from 590,000 last year.

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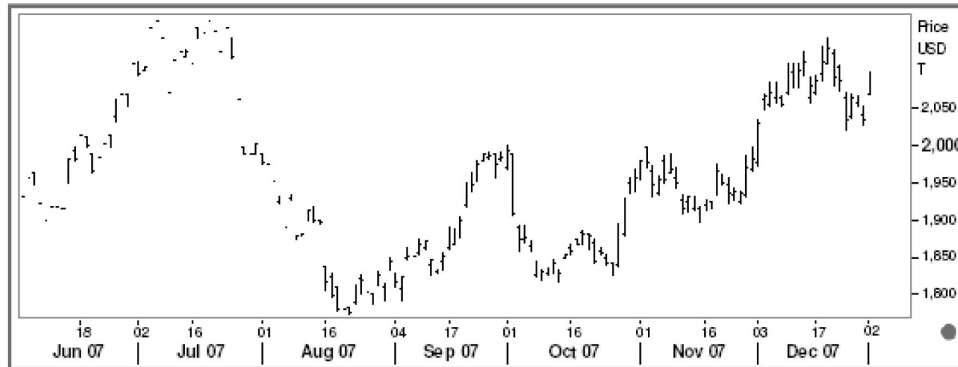
It is early for 2007-08 balance sheet forecasts. The sketchy estimates that have been released seem to indicate a move back into surplus in 2007-08, following a deficit of

about 250,000 tonnes in 2006-07. But with flat production and robust demand, we do not see how this is possible.

Maintain long positions.

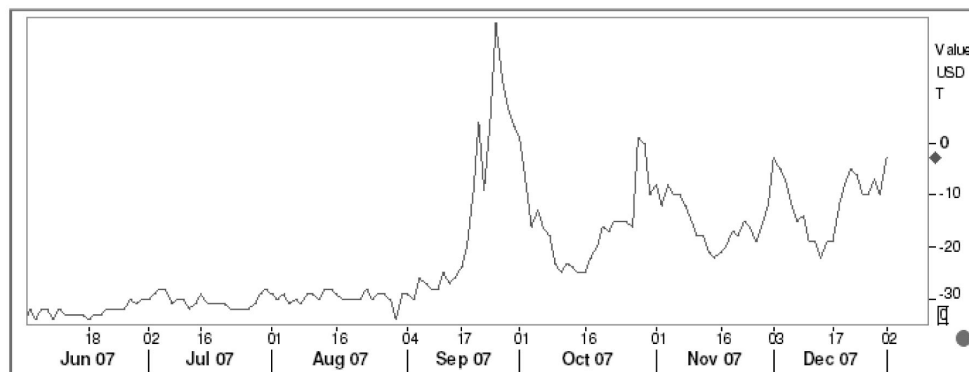
[January 3, 2008]

Chart 1 – March cocoa



Courtesy Reuters

Chart 2 – March/July spread



Courtesy Reuters

## SUGAR

### Transition from bear to bull is complete

For the longest time we've been harping on the bearish fundamentals of the sugar market. In the November 13 issue of Focus on Futures titled, "Sugar: on the brink of transition," we talked about looking for a bottom down the road, but it seems to have arrived a lot sooner than we expected.

High prices and the growth of the ethanol market whipped Brazilian and Indian sugar growers into a frenzy, which saw the world's two largest sugar producers increase crop size by about 30% over the past several years. Once all

this sugar flooded the market, prices fell by 50%, from 20¢ to 10¢ per pound (Chart 3). The global surpluses that resulted reached record highs of over 10 million tonnes.

The market spent most of 2007 in the relatively narrow confines of a 9.5¢- to 10.5¢-per-pound range. We believed that the market would continue to slide back to the pre-bull market levels of 8¢ per pound and below, but that is not the way the scenario has played out. Clearly we are still saddled with excess inventories, but the price base that was formed

from May and onwards obviously meant that sellers could not penetrate that level, because there were strong commercial interests that were happy to buy any weakness. In fact, until the recent rally took place, CFTC data show that commercials were net long from August through November. While the market still seemed to be in a bear market, the “smart” money was accumulating long positions while we were still sifting through what we can now probably call stale data.

There are several developments we can point to that underpin an assumption that the bear market has ended.

First, it now seems that Indian output for 2007-08 was somewhat overstated. Estimates have slipped from 32-33 million tonnes, to 30-31 million tonnes. While still mammoth, it could be the reason why the official government estimate for exports for the marketing year was lowered on December 20 by 1 million tonnes, to 2.5 million tonnes.

Although it's very early to expect any reasonable estimates for the 2008-09 crop, we do know that sugar area is expected to fall substantially in India.

Rising crude oil prices were not as much of a factor over the past few months as they might become in the coming months. First, the obvious: We're making new highs in crude, and demand for ethanol will almost certainly increase as long as it is competitive, which it is.

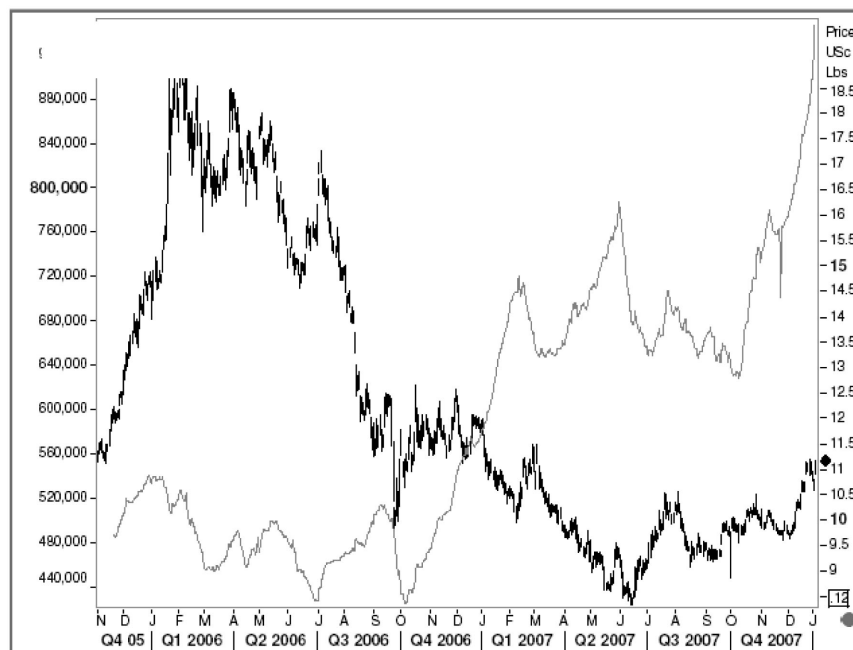
More importantly, once the crush in Brazil is complete, factors such as petroleum prices no longer affect the food-to-fuel ratio. With India becoming the new exporter to Asian purchasers, there were no supply issues. But now, as the new harvest approaches, a \$99-per-barrel price tag for crude oil will ensure that the food-to-fuel ratio will fall further.

One aspect of trading this market that will prove challenging is the size of the open interest. Almost every market has attracted large amounts of speculative capital since the bull market in commodities began. But the sugar market has been extraordinary in this regard. For many years, 200,000 contracts was considered a very high open interest. In the past 3 months alone, open interest has increased from 650,000 contracts to the current level of 900,000 contracts (Chart 3). The implication is the potential for large moves and countermoves, both of which can exaggerate the actual supply/demand fundamentals.

The markets are forward looking, and although the surpluses make the balance sheets look like a burdensome bear market, we believe that we have moved from bear to bull market. By the time the data tell you to buy it will almost certainly be too late. Fasten your seat belts and get long this market. Buy March sugar with an initial stop at 9.60, close only.

[January 4, 2008]

Chart 3 – Nearest contract weekly sugar (bar)/Open interest (line)



Courtesy Reuters

**SOYBEANS**

**Missing the boat**

Soybean prices have rocketed to levels not seen since 1974. Brazil is expected to overtake the US as the world's largest exporter of soybeans in the 2007-08 marketing season. In the meantime, however, the market is feeling the full impact of the huge shift of soybean acreage to corn in the US. Brazilian 2006-07 supplies begin to dwindle at this time of year, and the US becomes the world's supplier. With an expected US carryover of a mere 6% of consumption – compared with 19% the previous season – the market is concerned about running out of supplies.

The USDA raised its estimate of 2007-08 global production in its December supply/demand situation report by 800,000 tonnes, but also increased its estimate for consumption by 1.7 million tonnes. As a result, the estimate for ending stocks fell to a season low of 20% of consumption, down from 27% in 2006-07.

One of the hot issues that is driving the market is anticipation of the growth of the new sector of the market – soybean-oil-based bio-diesel. We haven't seen many headlines that drew attention to the USDA's 10% downward revision to the estimate for US methyl ester (bio-diesel) usage for 2007-08. Of course the bio-fuel market is for real, but as was the case with corn-based ethanol, the market got a bit ahead of itself with its exuberance for the cure-all remedy for high petroleum prices.

When actual bio-fuel consumption trends from the Department of Energy and the other energy-industry data-collection services began to show a slower than expected pace, it became obvious that usage estimates of the various feedstock that are turned into bio-fuel would have to be cut. And it would not be a stretch to assume that the USDA has more revisions up its sleeve, but is treading cautiously.

The weather in Brazil seems to be humming along nicely, and this is of course the most important near-term variable that we are now dealing with. The 62-million-tonne estimate for the Brazilian crop has been maintained for several months now.

Although there is strong historical precedent for downwards revisions – even this late in the growing season – there are no grounds to assume that something will go wrong until something does. If we do manage to bridge the gap between the period of availability of US supplies and the start of the Brazilian harvest, which is what happens most years, then there is no problem.

However, an examination of 2007-08 US export flows shows that demand is healthy. The USDA is forecasting that US sales will fall from last year, not because of slack demand from foreign buyers, but simply because the crop was 20% smaller than in 2006-07. The estimate for annual sales is 27 million tonnes, down from 30.43 million tonnes last year.

As of the most recent weekly report, export commitments stand at 20.7 million tonnes, up 1.1 million tonnes from last year at this time. This is where we can see the potential for tightness clearly. If exports were to continue at this rate and actually meet or exceed last year's level, after adding domestic consumption, US ending stocks would be even lower than the current forecast. A rough estimate would put US ending stocks at about 4% of consumption, and that would be the lowest on record.

In previous issues we've questioned the validity of this monster bull run in terms of whether it has reflected supply/demand fundamentals, and that skepticism has proven to be quite embarrassing. We're not about to try to save face at these levels.

Remain sidelined.

[January 4, 2008]

Chart 4 – March soybeans



Courtesy Reuters

**WHEAT**

## Running out

After a healthy correction, wheat prices – old and new crop – seem to have consolidated (Chart 5). There is a fair bit of uncertainty in the market, which we believe is keeping prices at these lofty levels. One would think that with Southern Hemisphere supplies becoming available, the market could relax somewhat. But with prices hovering at levels unimaginable to even the most exuberant of bulls as recently as this past spring, we're obviously not out of trouble yet.

Blaming the speculative community doesn't wash. Open interest in commodities in general has grown exponentially. Although wheat has been no exception, open interest peaked in mid-2006. Soybean prices, by contrast, which have also been skyrocketing, are more likely being fueled by commodity funds as evidenced by continuous growth of open interest in beans, meal, and oil (Chart 6).

The comparison becomes more meaningful when we look at the anatomy of the open interest. CFTC data show that commodity funds are net long a mere 11,000 contracts of wheat out of an open interest of 427,000 contracts. Contrast this with beans, where funds are net long 148,000 contracts out of a total of 555,000 contracts. The soy products have a similar configuration. Actually, Kansas City Board of Trade and Minneapolis Grain Exchange wheat contracts are heavily slanted to the net-long commodity fund side. But even after totaling the 3 wheat contracts, the net-long position is 63,000 contracts, out of a total of 611,000 contracts of open interest. All of which leads us to believe that a *bona fide* tightness has developed in the wheat market that will not be alleviated until the world's wheat farmers figure out a way to grow enough wheat to meet global demand.

Topping the list of key items that will affect wheat prices in the second half the marketing year and into the new crop year is the size of the US winter wheat crop. On January 11 the USDA will release its first estimate of 2008-09 winter wheat acreage. Informa Economics estimates acreage at 48.7 million acres, up from 44.987 million acres planted for the 2007-08 crop. November was very dry for the early development of the winter wheat crop, but

December was much improved. It's much too soon to know much about the health of the crop, but one thing for certain is that a disappointment on the acreage front will not go over well.

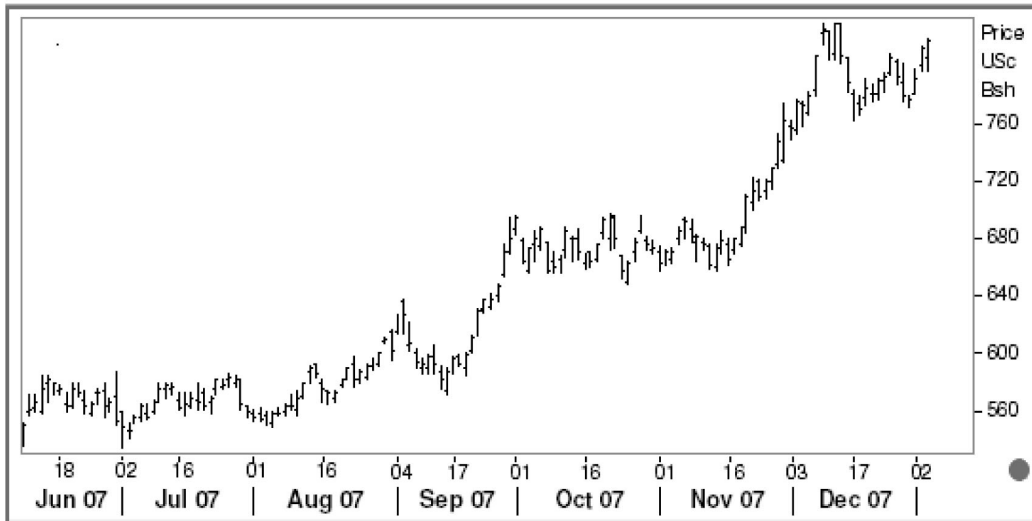
Prices began a retreat towards the end of December. The market may have been spooked by an item out of Russia. Although the initial reaction was muted, it helps explain why the market has started moving back up. On December 28 the government announced that it was imposing a 40% export tariff on wheat in order to curb domestic inflation. The measure will go into effect in early February and will be reviewed at the end of April when forecasters have a better handle on the condition of the winter crops.

This past week's export report showed dismal new sales right across the board for all US agricultural products, probably because of the holiday season. Wheat exports are still strong but have tapered off a bit. At the beginning of December, exports were running 84% ahead of last year, but that has shrunk to 76%. It doesn't really matter though because with 5 months left to the marketing year we're only 3 million tonnes shy of meeting the USDA target of 32 million tonnes. Of course, the possibility of cancellations exists. But considering that we've already shipped 65% of the expected final tally, compared with only 50% shipped last year of a much smaller total sales figure, the demand side looks pretty healthy.

Rounding out the roster for potential influential events in the near future – we believe – are the final results for Argentina. The government has maintained its forecast for a robust harvest of 15 million tonnes, despite 2 frosts in November, which at the time allegedly destroyed 2 million tonnes of wheat. It claims that excellent yields in other regions have compensated. Shortly after the frosts, the government closed off export registration in order to assess the damage. On December 26 it extended the closure. We think the jury is still out on the size of the Argentinean crop.

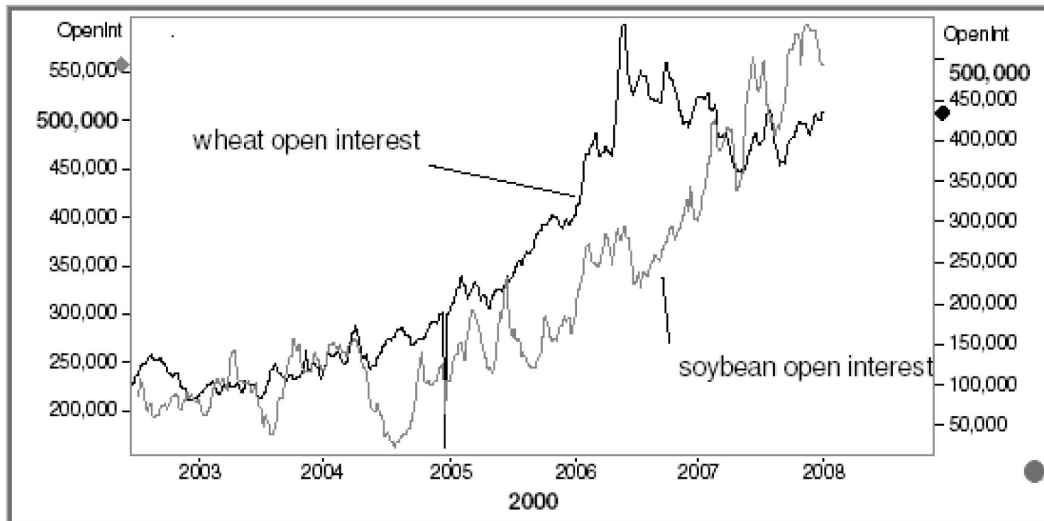
It could be a bumpy ride, but definitely remain long July Chicago Board of Trade or Kansas City Board of Trade wheat. [December 10, 2007]

Chart 5 – July wheat



Courtesy Reuters

Chart 6 – Open interest - wheat vs soybeans



Courtesy Reuters

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