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Getting sweeter all the time

India's back-to-back disastrous crops in 2008-09 and 2009-10 singlehandedly created the current bull market in sugar. With domestic consumption outstripping production by a wide margin, Indian inventories have been run down to a fraction of historical norms, and record imports were – and will continue to be – necessary to meet the country's estimated 23-million-tonnes of consumption.

In 2008, commodity market participants learned some painful lessons. Most prominent: Bull markets don't last forever, particularly in agricultural markets, because producers can quickly ramp up production if a strong profit incentive exists. Indeed, farmers were able to lock in prices that were ridiculously rich relative to their cost of production, and with falling demand, prices collapsed.

In applying the lessons of such recent history, many analysts are skeptical about the ability of the sugar market to maintain the current price level. After all, how many bad crops can India have? Profitability has certainly improved dramatically in any region that sugar is grown. This sentiment was reflected in the December 14 "Commodities Corner" column in *Barron's* magazine titled "Sugar's Prospects are Souring." Observations such as "sugar looks topsey" and "gains look unsustainable" set the tone of the analysts interviewed for the piece. Not a bull in sight.

Since the conclusion of trading on the session prior to the publication of that article, March sugar has rocketed to new contract highs of 27.05¢ per pound (Chart 1).

It's quite true that there is little reason to expect 2010-11 Indian and Brazilian crops not to reach optimum size and yield. On the other hand, it will take more than a one-year crop recovery to rebuild Indian stocks. Sugar is an important commodity in India, and for many years carryover stocks hovered around 50% of domestic consumption. The government has a *de facto* policy for managing the country's sugar inventories, with a system of import or export tariffs, depending on the environment. Most recently, the import tariffs were repealed to allow imports to compensate for the sharp drop in output. The government has extended the deadline for tariff-free imports several times over the past few months. The most recent extension goes all the way out to January 2011. India has undergone a transition from self-sufficient producer to importer.

To get an idea of just how tight supplies are in India, consider how the balance sheet is shaping up for the current marketing year. Beginning stocks for 2009-10 were 2 million tonnes. Combined with a 16-million-tonne crop and consumption of 23 million tonnes there's a gaping 5-million-tonne deficit. Imports to date for the 2009-10 marketing year are estimated at about 4 million tonnes, which means that more imports will be needed just to achieve a balanced market.

In early December the farm ministry announced that the comfort level for Indian sugar inventories is three to four months' supply – that's about 7 million tonnes, all of which will have to be imported.

In the very short term, India's import needs will be met from Brazil's new crop. However, there is no precedent for any importing country requiring as much sugar from the free market as India will in such a short period of time.

Early estimates are calling for a continuation of last year's trend in which the ratio of ethanol to sugar production in Brazil will slip. The extra 1 million tonnes or so of sugar that will become available for export are small change relative to the 5 to 7 million tonnes that we believe India will be looking for by mid-year.

The bears are prowling prematurely. Remain long.

[December 28, 2009]

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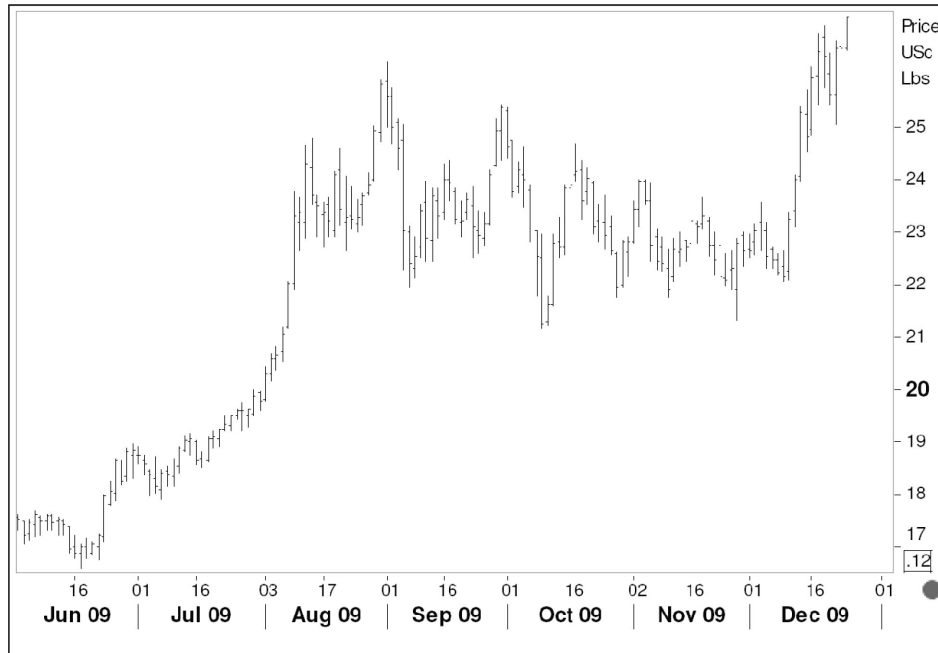
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Chart 1 – March sugar



Courtesy Reuters

COPPER

The copper bull continues to climb a mountain of bearish fundamentals

When the global economic slowdown broke the back of the copper market in 2008, prices fell freely and rapidly, from over \$4 per pound to just below \$1.25. Prices began to recover, however, even during the darkest moments of the recession (Chart 2).

There were two supporting factors. While the torrid pace of Chinese GDP slowed, the economy continued to grow. The expansion of cities and infrastructure creation hummed along, which kept base metal consumption strong – at least in China. Combined with a cutback in mine output by producing countries, the global balance sheet remained in deficit even while industrial production in the rest of the developed world continued to contract.

At this point it is fair to say that the bull market in copper is counterintuitive. The market is moving against the tide of traditional commodity-market economics. The cost of production for most major producers around the globe is a fraction of current market prices, which stimulates incentive to overproduce. Indeed, that is precisely what is transpiring.

Production in Chile, the world's largest copper miner, has turned around. In 2008, Chilean production was down 4% over 2007. While 2009 got off to a slow start, with average monthly output down 3.67% from January through July, production from August through November rose 8.58% over the same period in 2008.

Chilean output comprises roughly a third of global output and dwarfs production in other countries. Collectively though, material changes in production in other regions are important. Indeed, producers are expanding their copper mining activities in response to these high prices.

Indonesian output is estimated to increase by 17% in 2010. Significant gains in Peruvian output are expected over the next several years, with capacity anticipated to reach 2.1 million tonnes by 2014. Output in 2009 was about 1.28 million tonnes.

According to the International Copper Study Group's (ICSG) most recent report, the global deficit for 2009 stood at 52,000 tonnes at the end September, up from a

32,000-tonne deficit at the end of August, but down sharply from mid-year when the deficit peaked at 292,000 tonnes. If production trends continue, ICSG is still on track to meet its October forecast for a 2009 surplus of 370,000 tonnes.

The most recent import data available for China indicate that imports in November upticked from the previous month, but as Chart 3 shows, volumes are still significantly below monthly foreign purchases earlier in the year. There are forecasts that are calling for Chinese usage to grow by 10% in 2010, but that isn't necessarily as bullish as it seems. China imported a lot of copper in 2009 and mine production grew. Some analysts believe that excess inventories have accumulated as a result and will be drawn on in the coming months to meet demand.

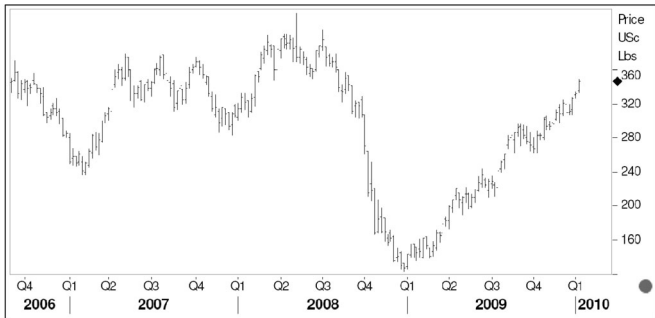
Global warehouse stocks have been rising steeply (Chart 4) and are back to 2004 levels, when copper prices were just peeking above \$1 per pound. However – and here lies the legitimacy of a long-term bullish argument – the stark picture of inventory build-up presented by Chart 4 is somewhat out of context. In using warehouse stocks as a

proxy for global ending stocks, we find that the copper market, like many other commodities, has not yet figured out how to meet the fresh needs of rapidly expanding developing economies. Global copper warehouse stocks peaked in 2002 at about 1.65 million tonnes. At the time, global consumption was running at 15.2 million tonnes, putting the stocks-to-use ratio at 10.8%. Estimated consumption for 2009 is 18.1 million tonnes, and with current warehouse stocks at 700,000 tonnes, stocks-to-use is a scant 3.8%.

The weak US dollar and a broad commodity investment frenzy are certainly key elements of this bull run. Copper prices – and those of many other commodities – are unlikely to withstand a significant dollar rally.

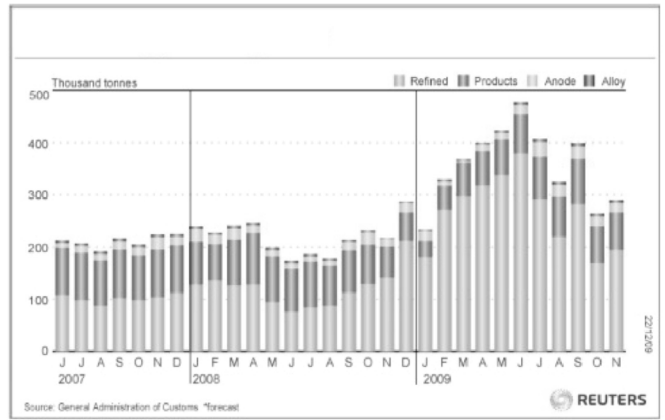
Our November 5 recommendation, based on our general bearish bias, was to establish positions in bear spreads. May/December (Chart 5) was trading at -0.45, and is now quoted at -1.50, in itself a testimonial to the lack of any bona fide tightness in this market. A minuscule profit, but a far cry from the potential disaster of an outright short. Maintain bear spreads. *[January 6, 2010]*

Chart 2 – Copper weekly



Courtesy Reuters

Chart 3 – Chinese monthly copper imports



Courtesy Reuters

Chart 4 – Global warehouse stocks

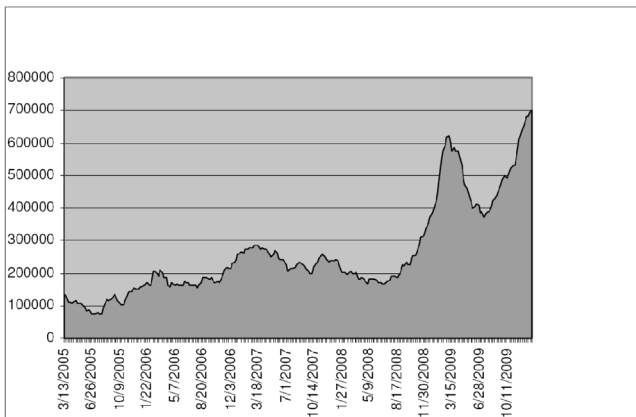
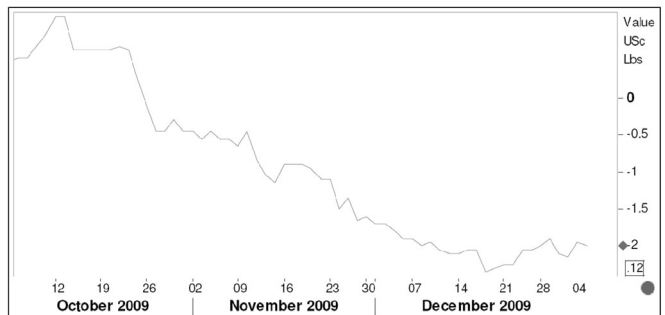


Chart 5 – May/December copper spread



Courtesy Reuters

WHEAT**Wheat aplenty**

The burst bubbles of many commodity markets have been reinflating. Not wheat, though. Prices are still about \$1 per bushel above the average price of the past 10 years (Chart 6), but that is unrelated to any wheat-specific dynamic. It's partly because the price of all internationally traded goods have to adjust for a weaker dollar and partly because the cost of inputs has raised the cost of production.

Global consumption increased by 3.6% in 2008-09, to 640 million tonnes, but output rose by 11.75%, to 683 million tonnes. This represented a complete recovery from the years of flat production, which had drawn inventories down from an average of 28% of usage between 2000-01 and 2005-06, to 20% in 2006-07 and 2007-08.

By the time farmers planned their 2009-10 winter wheat crops in the summer of 2008, prices were still very rich, but the fear of over-producing as we headed into the global financial crisis tempered optimism. Northern Hemisphere winter wheat planting was measured, which resulted in a slightly smaller global crop of 674 million tonnes, down about 2% from 2008-09.

Forecasts for 2009-10 consumption show continued moderate growth of 1.4%, and although the resulting surplus is about half that of the previous marketing year, ending stocks are now estimated at a robust 191 million tonnes, or 29% of consumption.

On January 12, the USDA will release its first look at US winter wheat acreage for the 2010-11 crop that will be harvested in the spring. Preliminary estimates show that US farmers are still very cautious about the global economy. The average guesstimate calls for 40.5 million acres, down sharply from last season's 43.3 million acres.

For the most part, production forecasts for other major Northern Hemisphere wheat exporters show that farmers outside the US are more optimistic about the prospects for an improvement in demand. The EU harvested 138 million tonnes of wheat in 2009-10, and early estimates, based on planted acreage, show that output will increase by 2.8% in 2010-11, to 142.2 million tonnes.

Estimates for Russian output are sketchy, but analysts report that wheat acreage is about the same or slightly higher than the area planted for the 2009-10 crop.

Other available early forecasts show that Chinese acreage is up just under 1% and Ukrainian area is down about 6% – but that drop is the approximate equivalent of only 1.2 million tonnes.

Consumption is dismal – at least insofar as US exports remain a reliable harbinger for global demand. Export commitments stand at 16 million tonnes, 26.5% below where they were last year at this time. While the USDA expects US exports to drop off sharply for the 2009-10 marketing year, we are running well below forecasted levels. The USDA estimate is 23.81 million tonnes, which is only 13.8% below last season. The pace of shipments is even worse, at 30% lower than last year.

Ignoring the most recent weekly export report, which showed sales at a laughable 93,000 tonnes, possibly because of generally slow, holiday-related activity, the four-week average for commitments was 295,000 tonnes. The wheat marketing year ends on June 1, and average weekly old-crop sales would have to average about 375,000 tonnes to meet the USDA forecast, which at present seems to be a tall order.

Projecting final 2009-10 exports based on the current flow of sales represents a throwback to a different era. It's a devastatingly bearish case for US wheat prices.

As indicated earlier, total global demand has been on the rise, which is likely to continue with the modernization of culinary trends in developing countries. Thus, a resurgence of demand for US wheat remains a vulnerable variable.

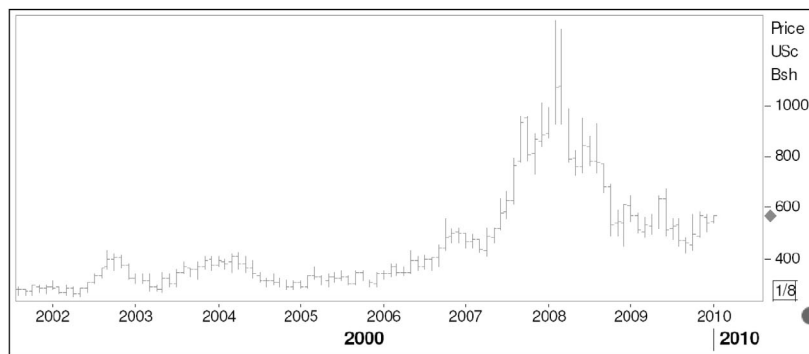
However, with burdensome global ending stocks, wheat prices seem destined to go nowhere. We're hesitant to recommend a short position as long as the dollar remains weak and the general appetite for the long side of commodities is strong among fund managers.

We made a strong bullish case for corn (see *Focus on Futures*, December 2), but spreading short wheat against long corn doesn't leave much profit potential, because it has already been priced into the market, with the spread already near historically low levels (Chart 7).

Stand aside.

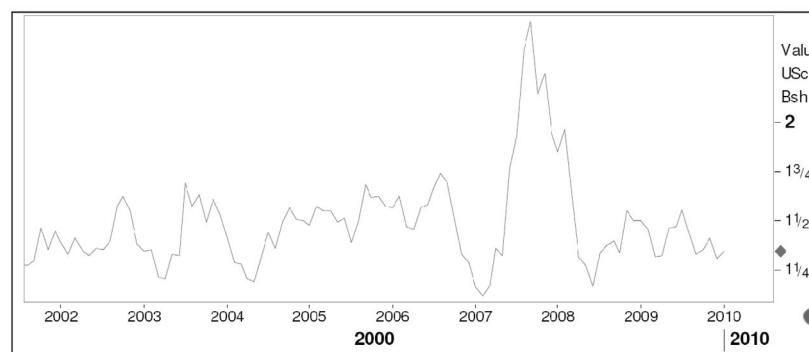
[January 11, 2010]

Chart 6 – Wheat weekly



Courtesy Reuters

Chart 7 – Monthly wheat/corn ratio



Courtesy Reuters

SOYBEANS

Could an uptick in US demand replace Chinese imports?

The bullish case for soybeans has revolved around a single issue: Chinese imports of US soybeans. Still relatively early in the marketing year, US export commitments stand at 32.2 million tonnes, compared with 20.9 million tonnes at this time last year. That's fairly close to the USDA forecast for 2009-10 US exports of 36.5 million tonnes. China accounts for 19.8 million tonnes of those sales, 12.9 million tonnes of which have already been shipped.

While new export sales for most other US agricultural products were a fraction of their norm in the most recent holiday-dampened weekly reporting period, soybean sales were 726,000 tonnes. That was below average for this season – average weekly commitments have been hovering around the 1-million-tonne-plus mark – but historically, still a large number.

The jury is out on how long the torrid pace of Chinese purchases can last. The Chinese government recently implemented some new import rules for soybeans, which may very well spell the end of the extraordinary buying spree. Coupled with a very bearish supply side, has this bull had it?

There's another demand component, however, which has been showing signs of life, but which has gone largely unnoticed. Crush margins have firmed in recent months. As a result, US consumption – as measured by crushings – has been on a bit of a tear lately. According to the US Census Bureau, we've had two consecutive months of excellent data. For October and November, the crush reached 163 and 169 million bushels, respectively. This compares with an average monthly crush of only 132 million bushels in the previous six months. The November number was the highest

monthly figure since December 2007.

In 2008-09 the US crush fell 7.8%, to 1.662 billion bushels. The USDA estimate for the current marketing year calls for a slight improvement, to 1.695 billion bushels. If these two strong months turn out to be the start of a trend, the USDA is likely to begin to increase the estimate. Even if we average only 150 million bushels for the remainder of the season, the estimate for the year is 130 million bushels shy. We can't just lop that off the ending stocks figure, because we are likely to see exports slowing down to some degree. It is, however, a new wrinkle for this market, because bears assumed that as soon as Chinese buying dried up, there would be nothing on the demand side to support this market.

The USDA is forecasting record output for Brazil and Argentina. In the case of Brazil, some beans are harvested early and will be available very soon. The USDA estimate for Brazil is 63 million tonnes, up from 57 million tonnes last year. Weather has been excellent, and most analysts have been raising their production forecasts. The official Brazilian government estimate jumped to 65.2 million tonnes.

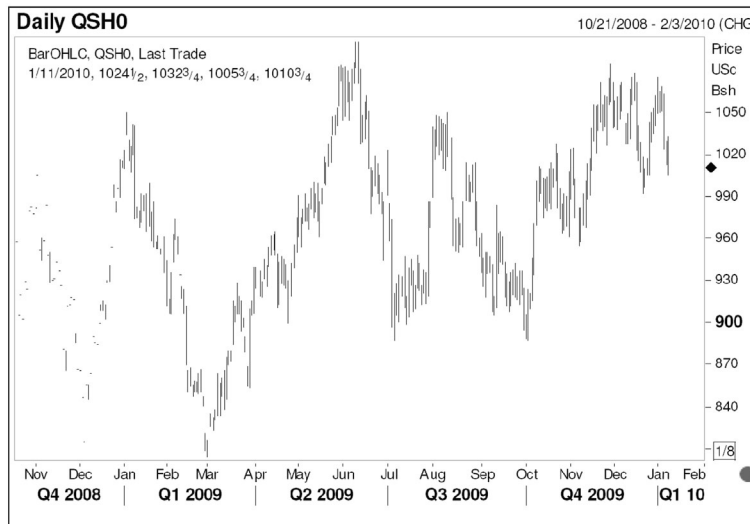
Argentina will still have record production, but its crop did have some weather issues, with heavy rain causing planting delays. The USDA estimate is 53 million tonnes, up dramatically from output of 32 million tonnes in 2008-09, when drought plagued the crop. But, the Agriculture Ministry lowered its estimate of planted acreage by 1.6% before the holiday, which could well prompt the USDA to lower its output forecast in the January 12 monthly supply/demand situation report.

Bulls can get excited by looking at the US soy picture in isolation. Despite the large crop, ending stocks are 7.9% of usage, still well below mid-decade, pre-bull-market days when the US carryout was as high as 18.7% of usage. But this is exactly the point. With South America growing so many soybeans, the US is no longer anywhere close to being the supplier of last resort. Global ending stocks are expected to climb to 24.4% of consumption, up from last year's 19.23%.

We see the market drifting in a range until there is a decisive change in the underlying fundamentals. Stay tuned.

[January 12, 2010]

Chart 8 – March soybeans



Courtesy Reuters

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