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Sugar: boring, but not for long

Sugar prices rallied earlier this year when a Brazilian crop failure looked to tighten up world supplies, just as the global market was recovering from two consecutive Indian crop failures. Most developments over the past several months, however, have not been terribly bullish, and prices were easy prey for the broad-based commodity selloff.

Indian 2011-12 production estimates have been firming up, which means that original export targets can easily be met. The government has extended the deadline to apply for export permits by one month, to mid-February. We continue to believe that running down India's stocks is not a good idea in the long run. Carryover stock levels are still well below the comfort level the world's largest consumer of sugar is accustomed to, even while demand continues to grow. Nevertheless – for the short term anyway – it should help keep prices contained.

Higher-than-expected production in the EU and Pakistan has compensated for the much-lower-than-expected output in Brazil. Estimates for the global 2011-12 surplus have been rising and now range between 6 million and 10 million tonnes.

That's the bearish case. There are, however, two major issues that we believe have built a floor, not too far below current levels.

First, we've pointed out several times in the past that the cost of production in Brazil – still the world's largest exporter – has been rising sharply over the past 10 years and is now not too far below current world sugar prices. Sugar statistician Czarnikow released a study this past September, which cites higher labor costs and the price of updating technology as the primary factors.

Czarnikow's report is somewhat futuristic, with a forecast for production costs to rise to 35¢ per pound over 20 years. But costs have actually shot up from a range of 10¢ to 13¢ per pound to a range of 19¢ to 20¢ per pound. If prices get too close to the cost of production, farmers will grow more profitable crops or divert a greater share of the cane crop to ethanol production.

This brings us to the second major development, which will surely have a strong impact on the sugar, corn, and ethanol markets for years to come. Congress has ended the era of protectionism for the US ethanol market. On

December 31 the 54¢-per-gallon tariff levied against Brazilian ethanol imports as well as the 46¢-per-gallon tax credit for US ethanol producers ended.

The market's reaction to what should have been a monumental event was muted. About 40% of the US corn crop is used to produce ethanol, up from a negligible amount 10 years ago. There are several reasons why it will be some time before the effects of the rulings are felt. Brazilian sugar ethanol is more expensive than US ethanol, because it is more environmentally friendly. But aside from that, the Brazilians cannot produce enough to make any appreciable dent in the demand for corn ethanol. For that matter, Brazil is actually a net importer of ethanol from the US. From January through October, the US bought 39 million gallons of ethanol from Brazil, but Brazil bought 156.3 million gallons from the US.

What will happen eventually, though, is that US ethanol producers will be tested, because they don't have any experience operating in a competitive environment. They have been receiving the tax credit since 1979 and did not have to worry about imports. These government programs are gone, but they did help build the ethanol industry, and to a degree, consumption is entrenched in the system because of the minimum ethanol blend mandated by Federal law.

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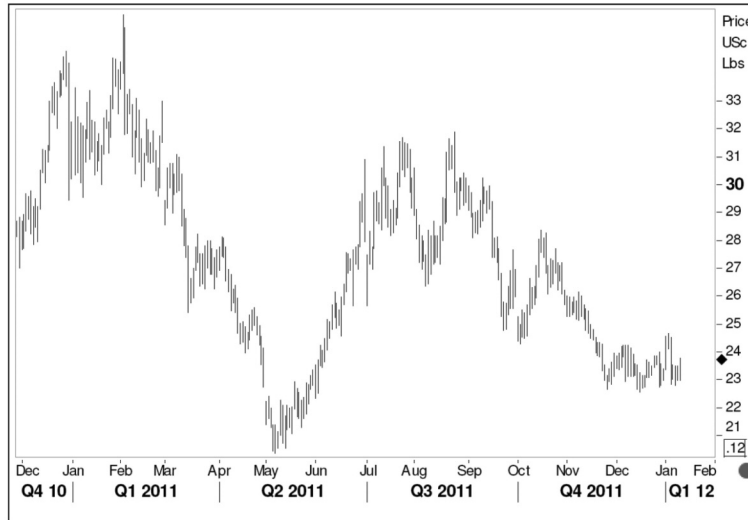
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If petroleum prices remain strong, Brazilians will be motivated to increase the portion of the cane crop dedicated to ethanol production, and sugar production will slip

steadily. We therefore see tight days ahead for Brazilian sugar output. *[January 12, 2012]*

Chart 1 – Nearest contract ICE sugar



Courtesy Reuters

WHEAT

Are US wheat export estimates understated?

Grain traders had to sift through an entire slew of USDA reports on January 12. The report that attracted the most attention was the first planting intentions report for the US winter wheat crop that was planted this past autumn. That crop will comprise over 70% of the wheat grown for the 2012-13 marketing year. The average of analysts' guesstimates was 40.933 million acres, but the actual figure came in slightly more than 1 million acres higher, at 41.947 million acres. That's substantially above last year's planted area of 40.646 million acres. Just to put that into historical perspective, US wheat acreage is still below some of the larger plantings of the past decade that averaged about 45 million acres.

Quarterly stocks as of December 1 were 45.134 million tonnes (1.656 billion bushels), 1.05 million tonnes (39 million bushels) below the average of analysts' guesstimates. That stood in contrast to corn and soybean stocks, both of which came in considerably above expectations. The market focused on the higher-than-expected acreage report, however, and prices plunged on the news, with March wheat falling by 36¢ per bushel (Chart 2).

The other noteworthy item was found in the regular monthly USDA crop report. The estimate for 2011-12 US exports was raised by 680,000 tonnes (25 million bushels). Export commitments stand at 19.95 million tonnes, down

from 26.19 million tonnes at this time last year. The USDA target is much lower than last year, though. Final sales are now forecast at 25.86 million tonnes, down from 35.08 million tonnes in 2010-11. Commitments continue to run at a slightly better pace than last year, but more significantly, shipments are very strong. Last year at this time, shipments were 68% of commitments-to-date and 51% of final sales. This year, shipments are 78% of commitments-to-date and 60% of final sales.

The sharp drop in prices in 2011 – cash prices peaked at \$9 per bushel last January – has stimulated some foreign trade. The problem, of course, is that the US has competition, primarily from the FSU. Total wheat output for the FSU is estimated at 114 million tonnes, up from drought-stricken 2010-11 output of only 81 million tonnes. There are several mitigating factors, though, that allow us to believe that demand will continue to outpace current estimates.

While all grain prices have been in a precipitous downturn, wheat prices have actually collapsed *vis-à-vis* corn. Wheat and corn have not traded at the same price since 1996. A glance at a chart of the wheat/corn ratio (Chart 3) paints a very clear picture of how far wheat prices have fallen relative to corn prices.

The deliverable grade of the wheat we trade in the US,

particularly the Kansas City Board of Trade and Minneapolis Grain Exchange contracts, is high protein content and used primarily for food. However, regardless of how rich in protein the wheat may be, an oversupply could make it cheaper feed than corn, which is what we've seen happen. It is probably the best explanation for the unexpectedly low level of inventories reported in the quarterly stocks report.

Australia is set to harvest a record crop of 28.3 million tonnes, but it has been a very wet harvest, which lowered protein content. This will be the second consecutive year in which a significant portion of the Australian crop will be downgraded to feed grade. The market for high-protein content wheat is in Asia, and if Australia cannot supply all of its needs, then we could see a surprise pop in US exports. To illustrate, consider that milling-grade wheat in Australia is

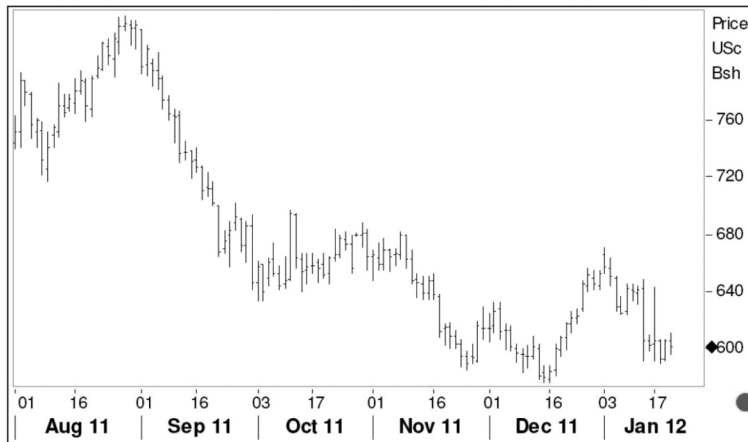
trading at \$350 per tonne, a \$120-per-tonne premium to feed-grade, which compares with the 10-year average of a \$30 premium!

We believe that US exports will surprise to the upside.

Despite the strong reaction to the planting intentions report, a brief look ahead to the upcoming Northern Hemisphere winter wheat crops indicates that the period of burdensome wheat supplies could be drawing to a close. A drought in Eastern Europe during the planting season will limit the size of winter wheat harvests. In the Ukraine, for example, about a third of the grain area was affected, and as a result, the government is already implementing a program to restrict exports to beef up domestic inventory levels.

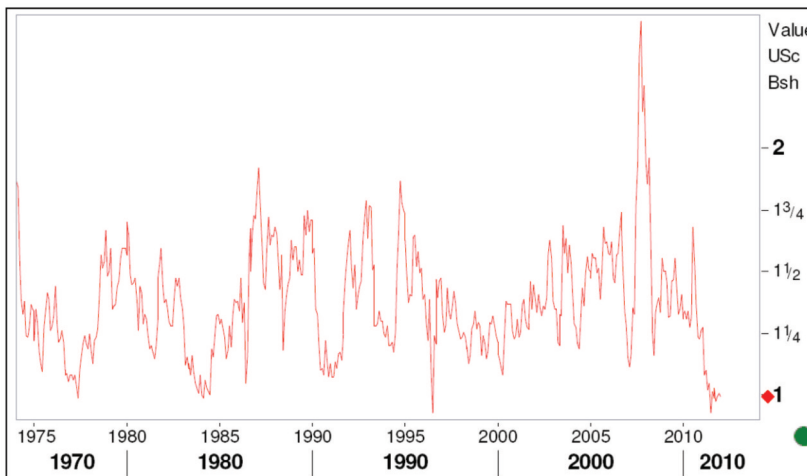
Buy March wheat. Place initial stops at \$5.70 per bushel, close only. *[January 20, 2012]*

Chart 2 – March wheat



Courtesy Reuters

Chart 3 – Wheat-corn ratio



Courtesy Reuters

SOYBEANS

The soybean bear grinds to a halt as poor weather threatens South American crops

Anticipation of record South American soybean crops ended a powerful bull run in the soybean market. Prices have fallen by more than \$3.50 per bushel since late summer. Not only would there be more beans available to Asian buyers than ever before, but South American farmers planted early for the second consecutive season hoping to capture more Asian business.

As it turns out, the crops will be neither as abundant as believed nor will they be early. Weather has wreaked havoc with the crops in both Brazil and Argentina. Severe drought in Southern Brazil and Argentina has forced crop estimates to be rewritten. Excessive precipitation in Western Brazil, where crops are ready for harvest, will delay the harvest and very likely lower yields.

US ending stocks were expected to reach their highest level since the 2006-07 marketing year. In the January USDA crop report, the estimate for 2011-12 was actually raised substantially, by 45 million bushels, to 275 million bushels, mostly a result of a 25-million-bushel downward revision to US exports. That would put the US carryover at 9.13% of consumption, up from 6.5% in 2010-11. In light of recent developments, however, that revision could prove to be a bit premature, as buying has shifted back to the US.

Overseas buyers are certainly concerned. For the most recent weekly period, the USDA reported that export sales were almost double the 4-week average at 990,000 tonnes, an extraordinary figure. China was not the only buyer. About a third of the total went to China, but the balance was scattered. China has been active in the market since, and we expect the upcoming commitment report on January 26 to show another week of stellar sales.

The January USDA crop reported revised Brazilian output down by 1 million tonnes, to 74 million tonnes. Argentinean output was lowered by 1.5 million tonnes, to 50.5 million tonnes. Those estimates are most likely dated. On January 24, German oilseed analyst Oil World

put Brazilian and Argentinean production at 72 million tonnes and 48.5 million tonnes, respectively.

The estimates are all over the place, but consider that if Oil World is anywhere close to accurately assessing the damage, the global balance sheet takes on a whole new complexion. Based on the revisions in the USDA January crop report, the estimate for 2011-12 global ending stocks would be 24.4% of usage, down a bit from the December estimate for 24.8%, but significantly below 27.2% at the end of the 2010-11 marketing year.

If we incorporate Oil World's estimates for South American output into the global balance sheet, we would see a much steeper drop for ending stocks, to 22.9% of usage. That would be a throwback to the inventory levels that sent soybeans to outrageous levels in 2008. We're not quite there yet, but Oil World qualified its estimates, cautioning that if we don't see some serious rain in South America, it could see further downward revisions to crop size.

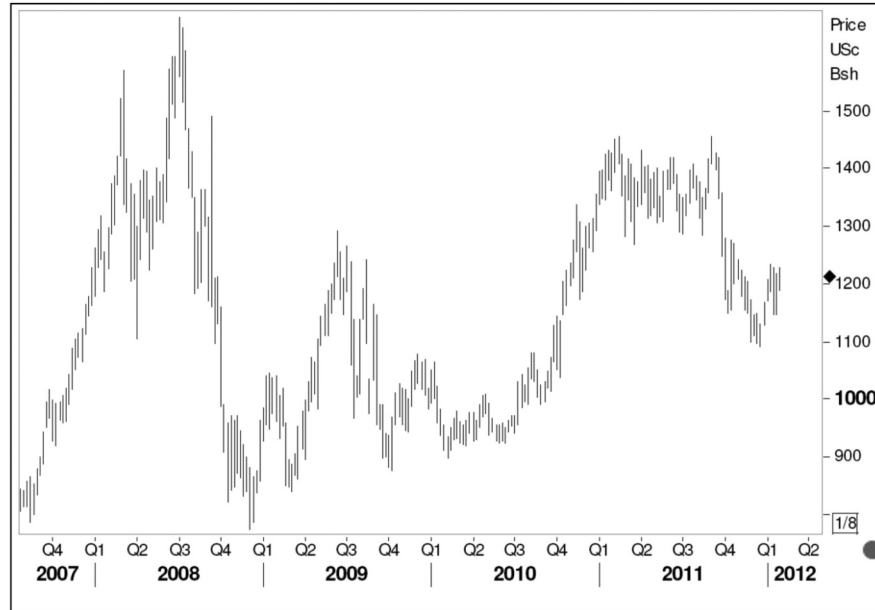
US farmers planted 75 million acres of soybeans for the 2011-12 crop. As we approach planting preparation for the 2012-13 season, Informa Economics weighed in with an early forecast for US plantings. Corn area is expected to expand at the expense of soybeans, with just over 74.5 million acres planted to soybeans. There is still ample time for acreage decisions to be switched, but prices will have to move higher to inspire farmers to increase soy planting.

Weather-market rallies can unfold in a flash. Yet it does seem that there was at least some measure of irreparable damage.

Buy March soybeans at the market to cover short positions, which replaces our November 14 recommendation to stop short positions at \$12.35 per bushel, basis the nearest contract. In addition, buy March beans to establish a long position, placing initial stops at \$11.50, close only.

[January 25, 2012]

Chart 4 – Nearest contract soybeans



Courtesy Reuters

CORN

Argentinean crop gets hammered

Rain has arrived in Argentina. Too little, too late, though. About 80% of the crop is past the pollination stage. The balance of the crop has just been planted recently and will benefit from the wet weather.

Any hopes that Argentina was going to alleviate tight global corn supplies have been dashed. Consider the magnitude of the disappointment. Based on acreage and trend-line yields, analysts expected a record crop that would be about 25% larger than the previous record crop of 23.3 million tonnes harvested in 2009-10.

The January USDA crop report responded to the drought by slashing the estimate for Argentinean production by 3 million tonnes from its December estimate, to 26 million tonnes. That is now ancient history. Forget about record crops. It is doubtful whether output will reach last year's 22.5-million-tonne harvest. Some estimates are as low as 17 million tonnes. With Argentina typically the world's second largest exporter behind the US, not only does the Argentinean crop do nothing for global inventory levels, it stands to exacerbate the problem of already low inventory levels that have plagued the corn market.

The 17-million-tonne estimate is something of a stretch. But even assuming that estimates for the drought-ridden crop fall to 20 million tonnes, that would lower 2011-12 global ending stocks to 122 million tonnes, or 14.07% of usage, down from 14.7%. Bears don't want to hear this, but that is down from 17.5% in 2009-10 and 15.2% in 2010-11. In fact, it would be the lowest global carryout since ending stocks began to plummet when ethanol producers began to share the US corn crop with the feed market in earnest in the early 2000s.

Well, it all sounds pretty bullish, but there are two mitigating factors.

First, while it is still a bit premature to speak of the 2012-13 US crop, there have been early acreage estimates. Informa Economics is forecasting that corn area will expand dramatically to 94.75 million acres, close to 3 million acres, or 3%, above the 2011-12 area. That would be a modern-day record and, with no surprise from the yield side, should produce a crop of roughly 14 billion bushels, which compares with 12.358 billion bushels and 12.447 billion bushels in 2011-12 and 2010-11, respectively. That

would be an increase of about 13% over last year and, even with moderate demand growth, would push the global balance sheet back to a carryover of perhaps 18% of usage.

The Argentinean situation is clearly a very bullish and unexpected event that could affect prices in the short term. However, a successful 2012-13 US crop, to be harvested in eight months' time, will dwarf the amount of corn lost to the South American drought.

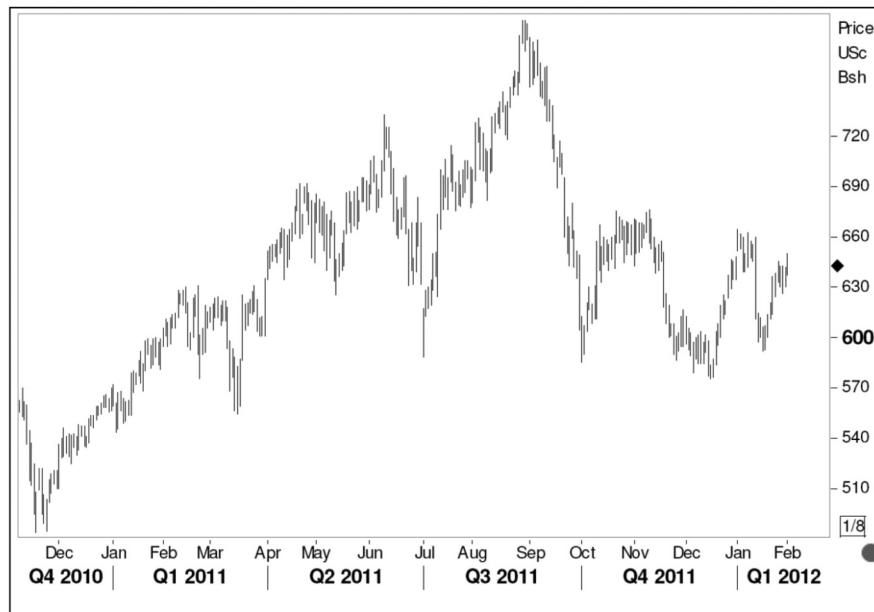
The other issue is the elimination of government subsidies in the ethanol market. As we mentioned in the January 12 issue of *Focus on Futures* regarding sugar, as of January 1 the 54¢-per-gallon tariff levied against Brazilian ethanol imports as well as the 46¢-per-gallon tax credit for US ethanol producers ended. Thus far, there has been no

impact. The USDA maintained its estimate for ethanol usage, at 5 billion bushels. Besides which, the Brazilians are in no shape to ship any significant amount of ethanol to the US in the present environment. They are actually net importers of US ethanol at the moment.

Eventually, though, US producers will be forced to compete with Brazilian prices, and there is no evidence that this will be possible without the comfort of the tariff and the subsidy.

On December 30 we advised using rallies to establish short positions. We no longer believe this is a wise strategy, because the Argentinean situation may be quite serious, and the market can remain strong for some time. Cover short positions for now, but stay tuned. *[February 3, 2012]*

Chart 5 – March corn



Courtesy Reuters

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