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Is the rationing process working for corn?

We've used the term "abysmal" – or the like – to describe US export sales for the 2012-13 marketing year, and we're running out of adjectives. Over the past two months, the combined weekly readings for the current and next marketing year have been close to zero. To reach even the USDA's rather low forecast of 29 million tonnes for the year, average weekly commitments would need to be in the 500,000 to 600,000 tonne range.

Year-to-date commitments stand at 12.77 million tonnes, down 49% from last year at this time, and are at their lowest level for this time of year since the USDA started keeping track in 1987!

Traders have watched incredulously every Thursday morning as the USDA weekly commitments report has continued to show almost no overseas sales, but reasoned that foreign customers were still recovering from sticker shock and would return sooner or later. Prices have fallen by as much as \$1.50 per bushel since they peaked in the summer, but there is still nothing happening.

While the silence on the US export front in itself would seem to be a clear indication that the rationing process is working by curtailing demand, the market's reaction to a slew of USDA data on January 11 actually sparked a rally.

First, the quarterly stocks report showed US December 1 inventories at 8.03 billion bushels, 250 million bushels (6.4 million tonnes) below the average guesstimate. This means that domestic consumption has been running at a much higher rate than anybody believed. The lower stocks figure was certainly not the result of the exports.

In the monthly crop report, the output estimate for the US crop harvested this past fall was raised by 55 million bushels. The export estimate was slashed by 200 million bushels, to 950 million bushels (24 million tonnes). No surprise on that front, of course, considering the sorry state of export commitments, as discussed above. That would be the lowest export total for the US since the 1971-72 season. Between the output and export revisions, the monthly update would appear to paint a fairly bearish picture. After plugging in the information from the quarterly stocks report, though,

the domestic feed estimate was raised by 300 million bushels, which actually made the report look bullish.

The estimate for 2012-13 ending stocks surprised traders, who were expecting a small increase in the estimate, to 667 million bushels. Because the increase in the domestic feed estimate was larger than the drop in exports, the revised figure for ending stocks came in at 602 million bushels (15.3 million tonnes), down from last month's 647-million-bushel estimate. We are assuming that a rationing process is now balancing the market. If this report is anywhere near accurate, we are still very far from accomplishing that. Before the drought hit, estimates for US ending stocks were close to 2 billion bushels. Rationing does not seem to have accomplished very much, so hence the rally.

The production estimates for South America were very bearish. The average guesstimate for Argentinean output was 25.9 million tonnes, down from the previous month's estimate of 27.5 million tonnes, but the estimate came in at 28 million tonnes. The Brazilian estimate was expected at 70.25 million tonnes, up slightly from last month, but came in at 71 million tonnes. More recent estimates are looking for even higher output numbers for Argentina and Brazil.

Despite the non-existent US exports, normally a harbinger for global demand, the USDA raised its estimate for glob-

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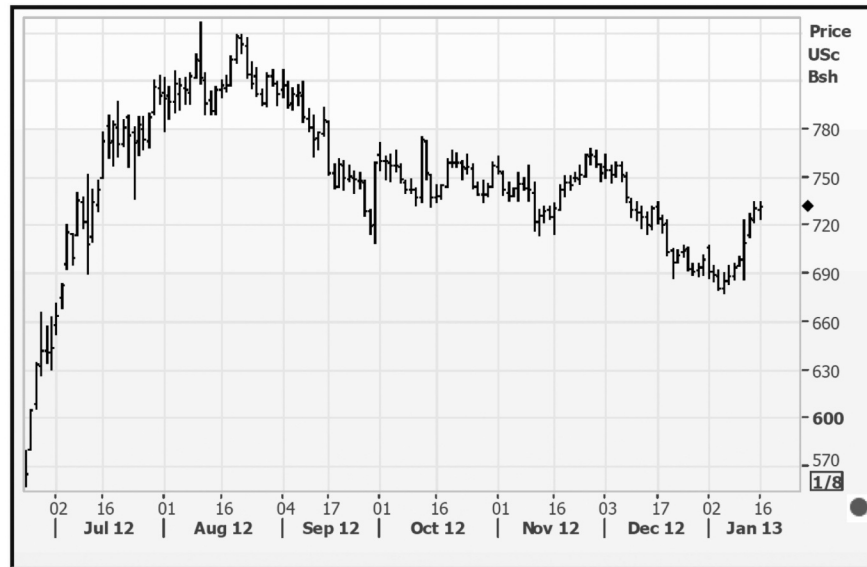
al demand by close to 6 million tonnes. The estimate for global ending stocks was revised down to 116 million tonnes, or 13.3% of consumption, down from 13.6% last month, and down from 15% at the end of 2011-12. That's the lowest carryout since the 1973-74 season.

If adhered to, our recommended stop on long positions at \$6.95 per bushel, basis the nearest contract, was breached.

(See *Focus on Futures*, November 17, 2012.) We are hesitant to recommend reestablishing long positions, mainly because if the US does not start selling some corn overseas, the market would have to fall to bring those buyers back. The rally is trading on very shaky ground. If you're not already stopped out, the \$6.95 stop should be strictly honored.

[January 17, 2013]

Chart 1 – March corn



Courtesy Reuters

BEAN OIL

US Congress helps build a floor under bean oil prices

When it comes to the US biofuel market, ethanol receives all the attention. To be sure, ethanol production and consumption dwarf the size of the biodiesel market. Nevertheless, biodiesel was thrust into the limelight recently. The January 1 deal passed by Congress to avoid the fiscal cliff included a provision to extend the \$1-per-gallon tax credit for companies that blend biodiesel with petroleum-based fuel through the end of 2013. In addition, the new legislation makes the extension retroactive to its December 2011 expiration.

Since biodiesel broke onto the scene in a meaningful way in the mid-2000s, approximately 10% to 15% of US soybean oil output has been used for biodiesel. Despite its relative low-profile status, soyoil-based biodiesel usage almost doubled in the 2011-12 marketing year from the previous year, to 4.87 billion pounds, from 2.73 billion pounds. The estimate for 2012-13 usage is slightly higher at 4.9 billion pounds. With smaller soybean crops over the past two sea-

sons, the combination of lower bean oil supplies and the jump in consumption have caused a sharp drop in ending stocks.

From the 2005-06 marketing year through 2011-12, the advent of biodiesel did not affect the availability of soybean oil. US ending stocks during that period averaged 14% of consumption. This year the estimate has fallen to 7.7% of usage. If the government's tax breaks are successful in stimulating production and ultimately usage, we can see inventory levels strained further.

Our original bullish foray into this market (see *Focus on Futures*, December 12) was based on a surge in US exports and was independent of any developments on the biodiesel front. At the time, the USDA was underestimating 2012-13 exports by a wide margin. That situation has been rectified, with upwards revisions in both the December and January crop reports. The estimate now stands at 980,000 tonnes, up from the 540,000-tonne November estimate. That is still well

above last year's final sales tally of 660,000 tonnes, but far below 2011-12 sales, which reached 1.47 million tonnes. Exports of soybean oil have been steady, but nothing like the volumes we saw in mid-November.

Is the tightness in the US indicative of tightness among the other major producing nations, or will South American producers, for example, pick up the slack? Global ending stocks averaged 9.3% of consumption over the past 10 years, but the estimate for 2012-13 has fallen to a modern-day historical low of 7.5%.

Argentina is expected to recover from last year's disastrous 40.1-million-tonne crop, which was down 18% from a year earlier. Early forecasts called for a 55-million-tonne crop, but growing regions have once again suffered from hot and dry weather, which has left the crops with insufficient moisture. Some analysts have lowered their estimates to 52 million tonnes.

Brazil, on the other hand, is enjoying favorable growing weather. While Argentinean estimates have been falling,

Brazilian estimates have been growing. The USDA raised its estimate for Brazil in the December crop report by 1.5 million tonnes, to 82.5 million tonnes. Still, the output losses in Argentina are larger than the increases in Brazil, and unless the weather improves, the South American supply side will put some further pressure on global inventories.

In conclusion, there are three separate issues that bear observation. First, it's hard to know how much of an incentive the new tax breaks in the US will be for biodiesel producers. At the very least, it is fair to expect some growth. Then, foreign demand has shown strength, and that could resurface. Finally, Argentinean crops will remain a wild card unless timely rains appear.

We were stopped out at 49.50¢ per pound as per our December 12 recommendation. The market has now broken out above the highs, with the potential to test the 2012 highs of 58¢ per pound. If you followed the stop, reenter long positions, and raise stops to 50.50¢ per pound, basis the nearest contract close only. *[January 23, 2013]*

Chart 2 – March soybean oil



Courtesy Reuters

WHEAT

Can a US crop failure spark a bull market?

Wheat prices have been in a precipitous decline since they brushed close-to-\$10-per-bushel highs back in August (Chart 3). Recent reports were mostly bullish.

The January 11 US quarterly stocks report was neutral for wheat, with December 1 inventories just about two million bushels above traders' guesstimates. The January crop

report, however, increased the estimate for feed-wheat usage by a more substantial 35 million bushels. That surprised traders and drew the estimate for ending stocks down from last month by a like amount.

The US winter wheat planting report was equally bullish. The street was expecting farmers to have taken

advantage of what are still historically very high prices, and plant lots of winter wheat. The acreage guesstimate called for a jump from last year, by 1.364 million acres, to 42.687 million acres. The actual figure came in at 41.82 million acres. Using the average of the planted/harvested ratio and yield over the past three years, the difference between the guesstimate and the actual figure is about 35 million bushels.

The initial reaction to the outlook for lower supplies for both the current 2012-13 and upcoming 2013-14 marketing years sparked a 60¢-per-bushel rally. There has been no follow-through, though, as the market consolidates the gains.

The smaller acreage estimate is exacerbated by poor weather for the winter wheat crop that was planted last fall. The key growing regions are suffering from low soil moisture. Kansas, Colorado, Nebraska, and Oklahoma are in desperate need of either snow or rain to replenish moisture. Millions of acres are at risk, with Kansas, the largest wheat producing state, in the worst shape.

The recently harvested Argentinean crop was much smaller than the 15.5-million-tonne crop harvested in 2011-12. While this has already been reflected in the USDA balance sheet, poor weather has resulted in recent additional downward revisions. The USDA lowered its 2012-13 estimate in the January crop report by 500,000 tonnes, to 11 million tonnes. In January, the agriculture ministry lowered its estimate to 10.1 million tonnes. Although Argentina is an important exporter, knowledge of its crop failure is in the market.

The saving grace for the wheat market has been the extraordinary Indian crop. Consider how quickly Indian farmers have expanded their wheat crops. In 2010-11 they harvested 81 million tonnes. Then in 2011-12 they topped

that with output of 87 million tonnes, only to better that in 2012-13 with yet another record of 94 million tonnes. India has turned from being a self-sufficient supplier with negligible exports of below one million tonnes to being a key player in world trade with estimated exports this marketing year of 6.5 million tonnes.

The estimate for 2012-13 global ending stocks stand at 177 million tonnes, or 26% of consumption, little changed from the previous month's estimate. That compares with 28% for the previous marketing year and 30% in 2010-12. Assuming the forecast for lower demand holds, it can hardly be considered a tight market. The mid-decade bull market began with global inventories at 20% of usage.

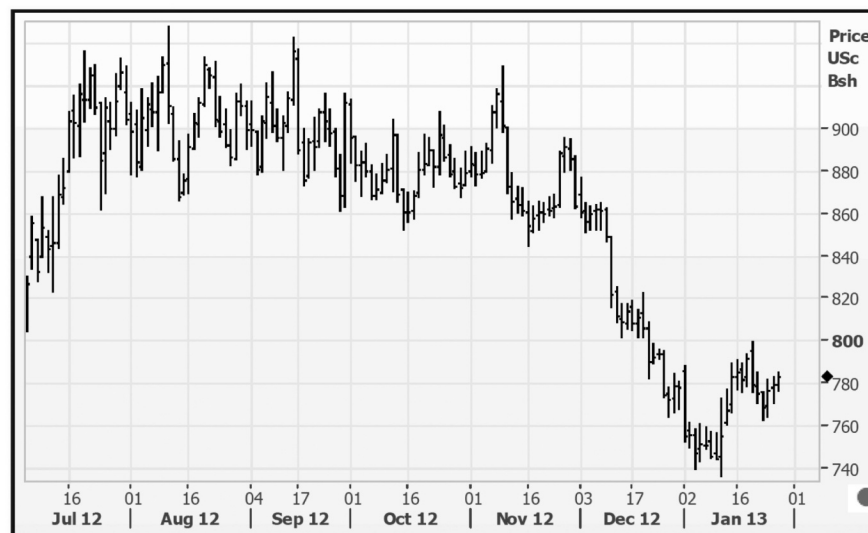
One variable, as mentioned, is whether demand is as weak as estimates say it is. In early December, already well into the wheat marketing year, which started on June 1, US export commitments were running 10% behind year-ago levels. As of the most recent weekly export reading, that gap has narrowed to only 3.5% below last year at this time. The USDA is forecasting that annual sales will be equal to last year's, at 28.5 million tonnes. If foreign sales continue at the accelerated pace, the USDA may have underestimated global demand.

The other factor is the health of 2013-14 crops. The Northern Hemisphere, Europe, and the FSU are coming off a devastating drought that slashed crops last year, but early estimates are for a return to normal crop sizes. Ukraine, for example, a key exporter, is set to bounce back with a wheat crop of 20 million tonnes, after last year's drought-trimmed 15.5-million-tonne output.

Indications are mixed. Remain sidelined.

[January 29, 2013]

Chart 3 – March wheat



Courtesy Reuters

SUGAR**Supplies bursting at the seam, or are they?**

Sugar prices have fallen to two-and-a-half-year lows amid forecasts for an ever-expanding 2012-13 global production/consumption surplus. The International Sugar Organization (ISO) has been revising its forecast higher, with its current estimate at 6.2 million tonnes, but some estimates are more than double that figure, at over 12 million tonnes.

The Brazilian crop staged a dramatic mid-season recovery. At one point it seemed that production would fall behind 2011-12 output, but the weather improved. Thus far, Center South output is running about 9% higher than the previous season's. Quite a turnaround.

Estimates for Indian output have edged slightly higher, to 24.3 million tonnes. After liberalizing the export market, exporters shipped 3.5 million tonnes in 2011-12. Export flows were expected to continue, but there has been very little activity on that front this marketing year. That is probably further indication that supplies from traditional channels are ample.

In terms of the supply side, there seems to be more of the same up ahead. Early forecasts for the 2013-14 Brazilian cane crop call for a 10% increase over the current crop. At first glance that would appear to be devastatingly bearish. There are a number of factors to consider, though.

The ethanol/sugar ratio has fallen substantially from a peak of over 60% a few years ago to 51% this year. There are two reasons Brazilians will be forced to produce more ethanol in the coming months and throughout the new marketing year. First, the percentage of ethanol required to be used by motorists is set to increase from 20% to 25% by June 1 or earlier. Then there is the export market to consider.

In our last article on sugar (see *Focus on Futures*, December 2) we said that optimistic estimates for Brazilian ethanol exports for 2012-13 were as high as 2.55 billion liters. That figure has now jumped to 3 billion liters, with forecasts for 2013-14 as high as 4 billion liters. Forecasts for the 2013-14 ethanol/sugar ratio are as high as 54%. With the US taking about 85% of Brazilian ethanol exports and ethanol prices becoming more com-

petitive with petroleum prices as crude oil moves dangerously close to \$100 per barrel, it is hard to say how much ethanol demand may grow.

Another issue that we've pointed to over the past few months has been the rising cost of sugar production, which presumably will make processors very keen on switching to ethanol – that is, if ethanol provides a better return on investment. One Brazilian sugar analyst says that production costs for sugar have risen to 21¢ per pound! The math is easy...at current prices processors are losing money. The analyst expects costs to ease if the cane crop is as large as expected in 2013-14, because it is idle milling capacity that increases average costs. Still, most people will be surprised to learn that the industry has been operating at a loss.

Sugar open interest has skyrocketed as trend-following funds and individual speculators continue to build a mammoth short position. Chart 5 shows that open interest is up 165,000 contracts, or 25% since this leg of the downdraft began in October. In addition, the chart also shows that speculators hold a net-short position of 73,000 contracts, the largest short position since 2006.

There is no argument with the bearish case presented by the global balance sheet. Down the road, however, it is hard to see sugar production continuing to rise in Brazil if there is a strong shift to more ethanol output. Even with current estimates for modest increases in the ethanol/sugar ratio, an abundant cane crop may not accommodate *any* increase in sugar production.

We were stopped out of our long-held long position at 18.50¢ per pound. We still believe that the market is oversold and that would be reinforced if the market fails to make even lower lows while not shedding a meaningful amount of open interest. As an alternative to jumping back into the market, we recommend buying call options. At present, they carry a very low implied volatility of 17%. That compares with historic volatility, which even recently has been 20% and much higher in the past. Buy July 19 calls.

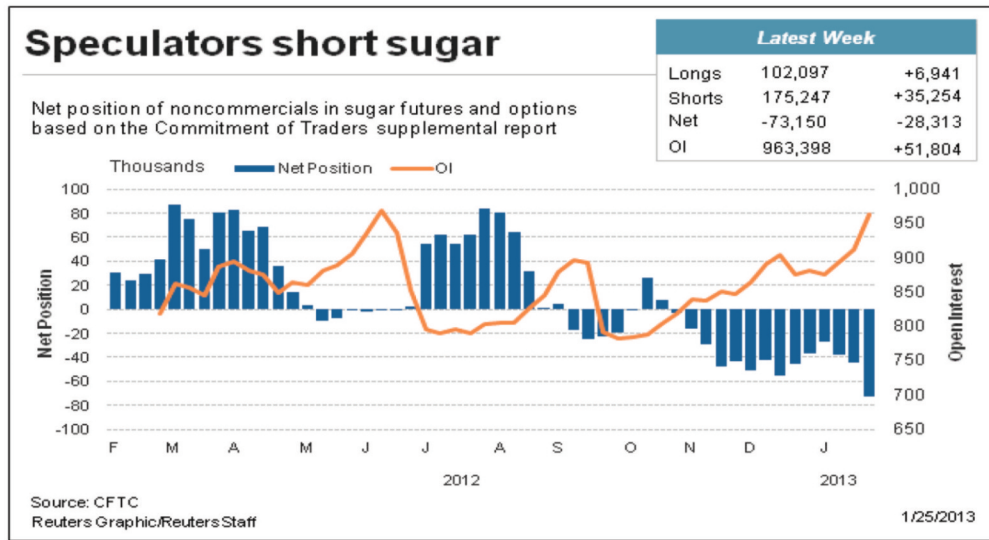
[January 31, 2013]

Chart 4 – March sugar



Courtesy Reuters

Chart 5 – ICE sugar open interest (line), Net short position (bar)



Courtesy Reuters

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