FRIEDBERG'S
FOCUS ON FUTURES

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Copper: breaking out of a bear market

At the peak of its glory days in the summer of 1995, copper traded as high as $1.45 per pound. At present, even after a 40% recovery from the lows, a pound of copper fetches only 85¢ per pound. The market has been trading in a 75¢ to 85¢ per pound range for close to a year (Chart 1). Is the market merely visiting the top side of the range? Or, have the fundamentals changed enough for the market to pierce the longstanding resistance level of 85¢ per pound?

The overwhelming influence on copper prices in the past five years or so has been rampant overproduction. To illustrate, consider that from 1994 through 1999, global output grew at an average annual rate of 6%. Consumption also increased, but despite a strong global economy, demand was restricted by the Asian crisis and grew at a rate of only 4% per annum. The resulting surpluses pushed prices all the way down to 60¢ per pound. Ending stocks as a percentage of consumption rose from 5% at the end of 1996 to 10% at the end of 1999. Mining companies kept producing even though prices were falling, because they were able to churn out copper at costs well below prevailing market prices.

Eventually, a wave of consolidation in the industry gave way to the closure of more expensive mines in Western countries. The era of excessive output was coming to an end. While production was still growing, the rate of increase was slowing. In 1999 production grew by 3.5%, while consumption grew at 5%, courtesy of the recovery in Asia. The annual global production/consumption surplus peaked in 1998 at 600,000 tonnes. By 1999, the surplus had shrunk to 300,000 tonnes.

In June, The International Copper Study Group (ICSG) published a report with estimates for the year 2000 indicating that the turnaround is complete. It estimates that the copper market will see its first global deficit since 1995. Consumption will grow by 550,000 tonnes, or 3.9%, in 2000, somewhat more slowly than it grew in 1999. Still, it will continue to outpace production, which will grow by 300,000 tonnes, or 2.1%. A decrease in the estimate of US production of some 400,000 tonnes is the most significant factor in the overall decline in output. And the trend will continue into 2001, according to ICSG. Production will increase by 2%, but consumption will rise by 3.8%, leaving a much larger deficit of 300,000 tonnes.

In the past few years there were times when production in Chile, the world's largest copper producer, was growing at close to 20% per annum. The most recently available figures out of Chile, however, paint a different picture. Output for the month of June from Escondida, the world's biggest copper mine, fell 14% compared with June 1999. Spokesmen for the mine said the shortfall was due to scheduled maintenance. However, when we look at figures for the first half of 2000, which show production falling 37,000 tonnes, or 7.5%, we see that the dropoff in output is not an anomaly.

Further evidence exists that the market is tightening. LME warehouse stocks have fallen dramatically. For 2-1/2 years, warehouse stocks skyrocketed from 250,000 tonnes to 850,000 tonnes. Since early March, that trend has been reversed, with stocks falling by about 330,000 tonnes. The cash-to-3-month contango in London has narrowed considerably from its range of the past few years to about $25 per tonne (Chart 2), indicating that there is some genuine tightness developing.

It is clear to us that the fundamentals have become bullish. From a trading strategy point of view, it should be noted, as we pointed out earlier, that the market bottomed last summer and has already rallied some 25¢ per pound.

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Another perspective, though, is that in broader, historical terms, prices are merely at the top of a base that has been forming since early 1998. Our track record with identifying breakouts that actually "break out" is, well, mediocre.

Recognizing the danger inherent in such endeavors, we are adopting a prudent approach and are recommending that traders position themselves on the long side of this market, but with caution. *[July 20, 2000]*

CURRENT STRATEGY: *Remain long September copper as per Flash Update of July 18. Raise stops to 82.50, close only.*

Chart 1 – Spot Copper

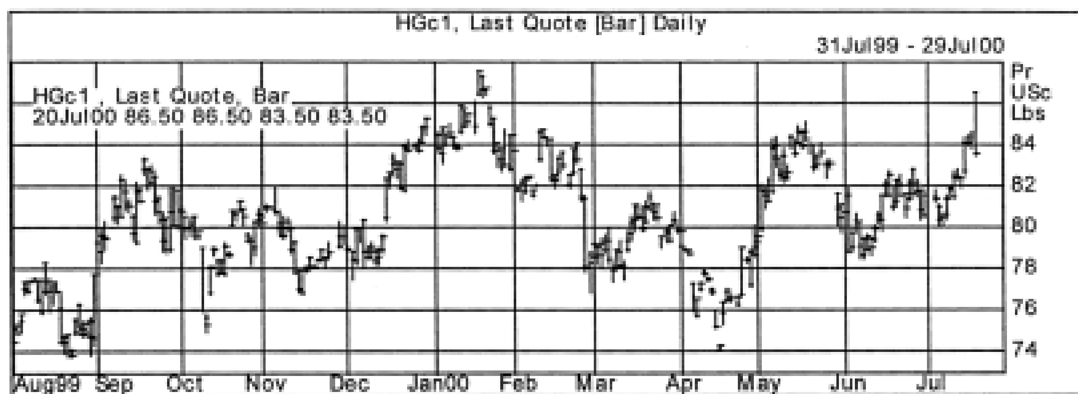
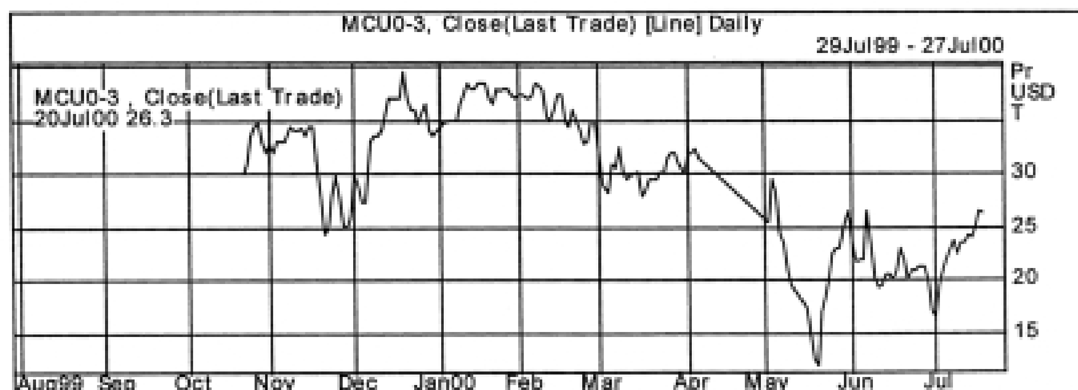


Chart 2 – Cash to 3-month Contango



Charts courtesy of *Reuters*

COTTON

The bottom is in

The July 12 USDA supply/demand situation report for cotton was greeted with a yawn by traders. The market was in the midst of a little bounce off fresh, six-month lows when the report was released. Analysts billed the reported as "friendly," and the market responded accordingly, closing the session with a modest 34-point gain. After reviewing the data more carefully, however, it seems that traders saw far more bullish implications in the supply/demand balances than the initial response reflected. In the following four days, October cotton rallied more than 4¢ per pound, or about 7%. What sparked this rather extraordinary delayed reaction?

Well, we don't know why there was a delay. The numbers were more than just "friendly." First, a little history. Cotton has been in a vicious bear market since 1995, when prices skyrocketed to $1.15 per pound. The market then went the way of most commodity markets, falling below 50¢ per pound, a level not seen since1988. After a dramatic recovery in production between 1993 and 1995, world cotton output tapered off for the balance of the decade. Still, ending stocks grew, because consumption was flat as well. By the end of 1999, ending stocks had bulged to a staggering 53% of consumption. Hence, the bear market.

A bullish tone was already being set back in May, when the USDA released its first look at the 2000-01 crop year. In that report it was estimated that world ending stocks would decline to 36.55 million bales, down from 40.76 million in

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1999-00 and 45.05 million in 1998-99. At that time, crops had not yet been planted, so it was a bit premature to make long-term forecasts. Nevertheless, the market ran up to post new recovery highs at 65¢.

Traders then turned their attention away from the big picture and focused on the US crop, which was benefitting from ideal weather conditions. They sent the market all the way back to test the previous lows.

Getting back to the July USDA report and the subsequent rally, it seems that the report has served as confirmation that global balances have tightened enough to declare an end to the bear market. Crops are well on their way, and we can, therefore, feel more confident that enough supply-side data is available for more accurate forecasting.

World production is estimated to grow to 87.37 million bales, up just under 1% from last year. This was revised upwards from last month's report by 370,000 bales. Consumption is estimated to rise by 1.4 million bales to 92.27 million bales, or 1.5%, but was revised up from last month by only 270,000 bales. Where, then, is the bullish case?

The big surprise was Chinese ending stocks. Burdensome stockpiles in China have been cited as one of the primary factors in this multi-year bear market. The USDA reduced its forecast for Chinese ending stocks to 10.78 million bales from last year's 15.28 million bales. This accounted for the entire reduction in global ending stocks. At 36.55 million bales, global ending stocks are dramatically lower than last year's carryover. They represent just 39% of global consumption, a far cry from the 53% at the end of the 1998-99 season. At the end of the 1994-95 season, when cotton prices were skyrocketing, ending stocks as a percentage of consumption stood at 34%. So while the market is still amply supplied right now, we are in a completely different environment than we have been in for the past five years. Accidents on either the supply or demand side will make the market far more vulnerable.

One sobering thought on the Chinese situation is that most analysts look at the reduction in Chinese stocks as an indication of strong Chinese demand that will continue to show up in the export market. Some, however, claim that the Chinese are merely trying to reduce their overwhelming inventories and that actual usage could remain stagnant.

The evidence at hand, however, remains quite constructive. US exports remain brisk and are ahead of the pace required to reach USDA projections for 1999-00. New crop sales these past few weeks have been strong as well. Open interest is at fairly moderate levels, indicating that the market has not been inundated with speculators. Such an inundation would exacerbate price movements. In fact, the limit-up day this week seemed to attract little interest.

We continue to monitor crop developments and export sales, but we believe that this market has seen its lows.

[July 21, 2000]

CURRENT STRATEGY: *Remain long December cotton as per Flash Update of July 27. Maintain initial stops at 58.50, close only.*

Chart 3 – October Cotton

Chart courtesy of *Reuters*

COCOA

In transition

It seems as if cocoa does nothing but get cheaper all the time. Cocoa has lost about half its value since prices began falling in mid-1998. Indeed, year after year of bumper crops in the world's biggest producer, the Ivory Coast, and sluggish growth in consumption have inspired confidence among the world's chocolate manufacturers that ample supplies will be available as their needs arise. It's a perfect recipe for a bear market. Even the most optimistic analysts in their most bullish moments talk about cocoa trading up to the top of the 8-month-old range of $750 to $900 per tonne.

In the same fashion that rallies have been turned away at the top of the range, the market has not made any downside progress in some time (Chart 4). Spot cocoa traded at the current level of $850 per tonne back in November of last year. The market did try – unsuccessfully – to penetrate below $750 per tonne twice this year. The formation of such a base is indicative of a market that is in transition from a state of abundance to one closer to balance. While carryover stocks are reportedly still in excess of 40% of consumption, the pronounced bearish fundamentals that brought the price of cocoa to such depressed levels have mellowed.

On the surface, the supply side offers little relief to the bearish case. According to ED&F Man's latest report, the Ivory Coast will harvest another record crop this year of just over 1.3

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million tonnes, or roughly one third of world output. World production for the 1999-00 season will rise by about 5% to 3 million tonnes. This has been well known for some time and should not serve as a source of any additional weakness. ED&F Man lowered its estimate for the global production/consumption surplus slightly to 84,000 from its previous estimate of 95,000 tonnes. This reduction was primarily a result of adverse weather conditions in the Ivory Coast late in the season.

The second biggest producer, Ghana, with a crop of 455,000 tonnes, keeps cranking out bigger and bigger crops every year. Actually, this brings us to a general point about the vulnerability of cocoa. Four West African nations – the Ivory Coast, Ghana, Nigeria, and Cameroon – together produce more than two thirds of all the cocoa beans grown in the world. The four countries are located in one climatic region. If there ever were major weather problems, well, you know the rest.

Indonesia is the only country in a different region that still produces a significant crop. It is the world's third-largest producer, with output this year of 400,000 tonnes, according to ED&F Man's recent report. Production has increased steadily over the years. There is a problem, however, in that Indonesian cocoa plantations have pest infestation, a problem possibly of the same magnitude as Brazil's witch's broom disease. In the mid-1980s, Brazil produced over 400,000 tonnes of cocoa. This year, Brazil produced a mere 132,000 tonnes. Analysts report that some areas in Indonesia are infested with the pod borer moth and that they may lose as much as half the crop in five years. Just today, there were reports that output may fall to as low as 370,000 tonnes because of these pests.

These issues are somewhat futuristic, but it is worthwhile to remind ourselves every so often why we watch this market for signs of a bottom, even in light of the fact that carryover stocks could take years to be consumed. Clearly, the limited sources of supply are a unique feature among commodities. The only other commodities that we trade that have a similar problem are the platinum group metals, and look what happened to them.

Getting back to reality, the strength in cocoa prices we saw from 1993 to 1998 (Chart 5) was associated with production/consumption deficits. The amount of ending stocks was not very different from the current level. As a percentage of consumption, ending stocks during that period ranged from about 35% to 45%, compared with the current level of somewhat over 40%. It was not as if the world was running out of cocoa in those years. Rather, fear alone of a reduction in available supplies was enough to inspire a bull run.

The assumption that we will continue to run surpluses is keeping the market confined to the sub-$900-per-tonne territory. ED&F Man estimates that grindings are 5% higher than last year. And this is certainly something that has changed. Over the past five years, global consumption grew by an average of 2.5% per annum while production grew at 5%. It is far too early to talk about specific numbers for the 2000-01 crop year. All we know is that pod setting got off to a late start in the Ivory Coast, and the crop will therefore be vulnerable to dry conditions.

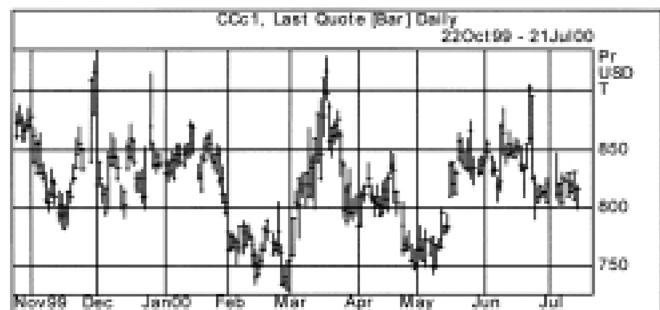
What we do know, however, is that if current consumption patterns continue, production for 2000-01 will have to match this year's to avoid a deficit and the accompanying anxiety that will surely drive prices higher.

African producers recently threatened to destroy 250,000 tonnes of cocoa to alleviate the drag on prices caused by the burdensome stockpiles. Even though 250,000 tonnes is a lot of cocoa, nobody has taken this very seriously. They probably won't do it, and if they did, they'd be destroying poor-quality beans anyway. But that's not the point. The point is that we see from this and other plans these countries contrive to get prices moving that producers are suffering from low prices. They have little incentive to spend what they earn on pesticides to ensure good-quality crops in the future.

Cocoa is cheap at these levels. We remain on the sidelines but watch eagerly for developments. *[July 26, 2000].*

STRATEGY: *Stay tuned.*

Chart 4 – Spot Cocoa (Daily)



Charts courtesy of *Reuters*

Chart 5 – Spot Cocoa (Monthly)

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CRUDE OIL

OPEC production hikes spell the end of the bull market

The major peaks and valleys in the price of crude oil can be traced to changes and anticipation of changes to OPEC output policies (Chart 6). At the start of the mammoth rally that saw the price of crude oil rise by close to $25 per barrel, OPEC was in disarray. It took some time before its members' collective strength could be harnessed to halt sliding prices. OPEC began to cut production in March 1998 and continued to cut for over a year until it had reduced output by 4.2 million barrels per day (bpd). The market did not bottom until early1999. When it did, it did so with a vengeance. Crude oil prices surged almost without interruption for well over a year until they had more than tripled.

In early March of this year, talk alone that OPEC was going to begin to reverse the process sent the market into a tailspin. Crude oil shed about $10 per barrel. On March 8 the market began to plunge when the media reported that OPEC was seriously considering yielding to pressure from consumers and the US government to do something about soaring energy costs.

The most recent hike of 708,000 barrels per day, announced in June, elicited a delayed reaction. When word spread earlier this month that the Saudis were going it on their own with an increase of 500,000 bpd, the market finally responded by plunging $3 per barrel in just a few sessions.

Although we cannot attribute market extremes to the opening and closing of OPEC spigots directly, it is very clear that major moves are associated with the flow of OPEC oil. As such, with OPEC production at 28.2 million bpd, it will become increasingly difficult to ignore the fact that output is almost back to the level that drove the market all the way down to $10 per barrel (Chart 7).

The biggest difference between the current environment and conditions in early 1998, of course, is demand. At that time we were in the thick of the Asian crisis, and consumption had been mostly flat since 1996. During 1999, when economies around the globe were moving full steam ahead, demand took off (Chart 8), and the market was being squeezed by OPEC's 4.2 million bpd cutback.

The market remained strong until just recently, because it continued under the illusion that demand is as strong as it was last year despite the fact that available data indicate otherwise. As we illustrated above, the market remained strong even after the last official increase in June of 708,000 barrels (Chart 6). Oil industry analyst EMC estimates that demand grew 1.8% in 1999, and will grow at 2.5% in the current quarter. For all of 2000, it estimates that consumption will grow at 1.7%. But, as Chart 7 indicates, demand actually peaked last fall. While economies are still growing, they are not growing at quite the torrid pace that they have been the past two years. While economic activity was robust, the market absorbed OPEC output hikes, almost without breaking stride. It took the informal 500,000-barrel increase by the Saudis to break the market.

Until the market broke down from the $33 per barrel range a few weeks ago, we continued to hear about tightness. The drawdown of stocks actually ended months ago, particularly in the strongest sector of the complex, unleaded gas, where API stocks bottomed in November 1999 (Chart 9). Backwardation in crude oil has collapsed (Chart 10).

The unilateral move by the Saudis may well indicate that the period of harmony among OPEC members is over. The temptation to overproduce while prices are still relatively rich must be overwhelming.

In conclusion, we believe that the combination of OPEC's return to production levels of early 1998 and more moderate demand growth means that we have seen the top of this market. *[July 28, 2000]*

STRATEGY: *Remain short October crude oil as per Flash Update of July 27. Lower stops to 28.75, close only.*

Chart 6 – Spot Crude Oil

Charts courtesy of *Reuters* and *Bloomberg*

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Chart 7 – OPEC Output

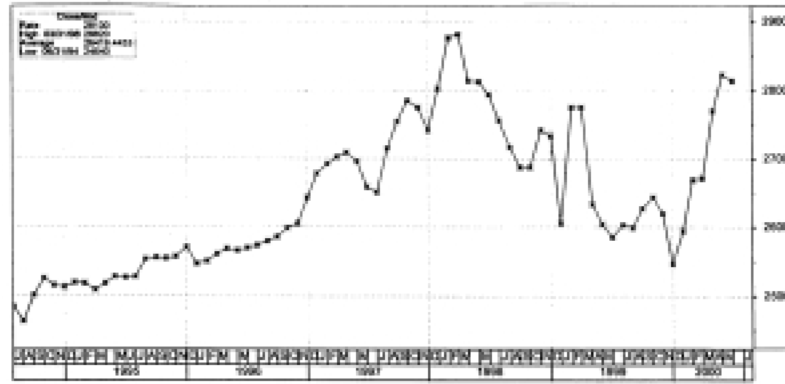


Chart 8 – Global Product Demand

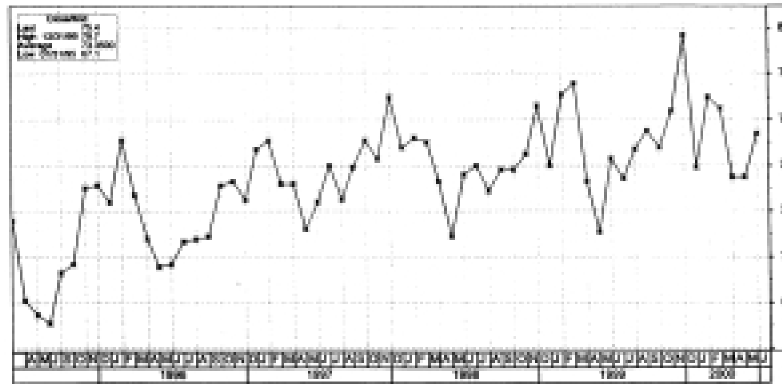


Chart 9 – API Gasoline Stocks

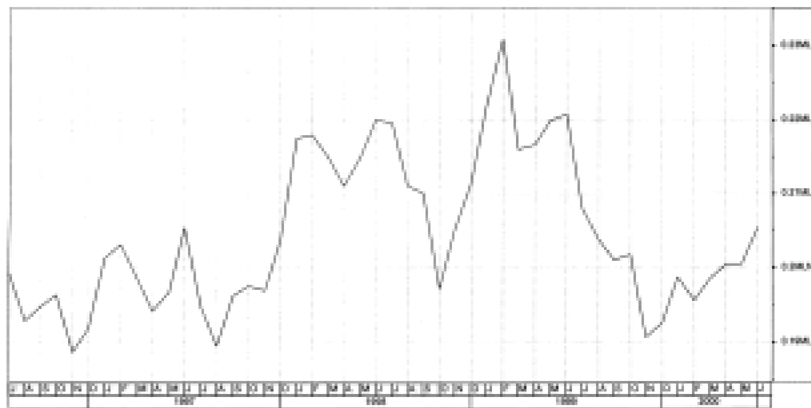
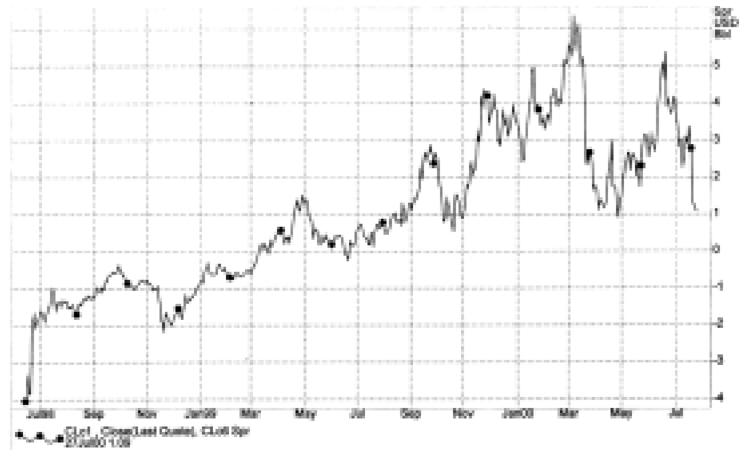


Chart 10 – One-Month to Six-Month Crude Spread



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ROUNDUP

Checking up on winners, past and present

Platinum

The fundamentals for platinum have not changed; they are as bullish as ever. On the supply side, the major influence remains the absence of exports from Russia, which is counted on for 20% of world supplies. While some Russian platinum has been showing up, the volumes are simply not there. It is now more than a year since normal volumes have been coming out of Russia. Some optimism emerged recently when Russia's sole export agent entered into contracts with Japanese buyers. The latest news on that front, however, is that shipments have been delayed to the fourth quarter. The nagging question is ever present: If they have it, why aren't they shipping it?

On the demand front, again there is nothing very new. Jewelry demand in Asia has taken off. Developing countries around the globe – particularly and most significantly China – are rapidly introducing emission-control legislation. This sector of the market promises to create explosive demand for platinum, as well as palladium.

Speaking of palladium, we should point out that fourfold increase in price is also a very bullish fundamental factor for platinum. When palladium was cheap, it was introduced as a substitute for platinum. However, the introduction of palladium was so successful that prices have now become prohibitive.

We expect these bullish fundamentals to continue to be a factor. Nevertheless, we are not long at the moment, mostly because we had the misfortune of being stopped out at the low of the last corrective move earlier this month. We did not pursue getting back in despite the presence of the solid bullish case. There are a number of reasons for this.

South African miners are not sitting idly by. They are working feverishly to fill the gap in supply left by insufficient Russian shipments and growing global demand. For example, Amplats, a South African mining company, plans to increase capacity by 500,000 ounces by the year 2003, according to Johnson Matthey. Such an increase represents a staggering 10% of current world production.

Although we believe that demand is growing enough to absorb much of the new production, we also believe that one has to become more price-conscious when looking to buy platinum after such strength. One-month lease rates have plummeted to 15% from a high of 70% earlier this year, which means that short-term tightness has been alleviated to some degree. We maintain a keen interest and watch for developments. *[July 28, 2000]*

STRATEGY: *Remain sidelined.*

Sugar

The sugar market has been fed a steady diet of bullish news. Prices have responded in kind. October sugar has just about doubled in price from its contract lows. We are now back to early 1998 levels.

The most recent item to push the market to yet another contract high was a report out just a couple of days ago that the 2000 Australian sugar crop was downgraded again to 4.2 million tonnes from the previous estimate of 4.5 million tonnes because of disease. This compares with last year's output of 5.5 million tonnes. Australia is a major player in the export market, having shipped 3.8 million tonnes last year. Trade sources indicate that it will have only 3.3 million tonnes available for export this year.

The shortfall in Brazilian and European Union crops has been well known for quite some time now. While the tighter global supply situation caused by these crop failures will be a factor in the physical market for some time, we must realize that it has already been priced into the market.

We've been riding this bull almost from the lows. It is time to play the devil's advocate to ensure that we don't lose sight of reality. We must stay alert for changes that will allow us to keep the profits that we have earned.

The daily sugar report of German analyst F.O. Licht helps us achieve this. This morning's report pointed out that Brazil is cutting to 22% from 24% the (sugar-based) alcohol content of the alcohol/gasoline mix widely used for engines in Brazil. This could free up a much as 1 million tonnes of sugar, which would more than compensate for Australia's lost output. Licht also caution that "...it should not be forgotten that the change in fundamentals is not due to exceptionally high import demand or a sharp increase in sugar consumption but to weather induced production problems. The capacities are still there, and if weather returns to normal, the market could face the old problem of oversupply."

Having said that, the market continues to hum along, posting steady gains day in and day out. The open interest is amazingly well behaved. Past bull runs in sugar seemed to bring speculators out in hordes, but in this case, the open interest has dropped about 40,000 contracts during the last 3¢ of the move. Given the fine technical performance and the overall bullish fundamentals, analysts are obviously writing positive reports.

Still, buyers seem to be sidelined. We're still happy with the position, but watching very carefully. *[July 28, 2000]*

STRATEGY: *Remain long October sugar as per Flash Update of March 24. Maintain stops at 9.30, close only.*

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HOTLINE UPDATE

Flash Update: **Wednesday, July 5, 2000:**
Good afternoon for Wednesday, July 5, 1:20 pm. This is a Flash Update. We have liquidated our long October platinum position at 519.

Flash Update: **Thurday, July 6, 2000:**
Good Afternoon for Thursday, July 6, 12:20 pm. This is a Flash Update. We have liquidated our long August CRB position at 217.90.

Friday, July 7, 2000:
Good afternoon for Friday, July 7, 5:05 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long August gold, with our stop at 275; and long October sugar, with our stop at 7.95. All stops are close only.

Friday, July 14, 2000:
Good afternoon for Friday, July 14, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long August gold, with our stop at 275; and long October sugar, with our stop at 7.95. All stops are close only.

Flash Update: **Tuesday, July 18, 2000:**
Good morning for Tuesday July 18, 9:40 am. This is a Flash Update. We have purchased September copper at 84.60, placing initial stop at 80.60, close only.

Friday, July 21, 2000:
Good afternoon for Friday, July 21, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long August gold, with our stop at 275; long October sugar, with our stop at 7.95; and long September copper, with our stop revised to 82.50. All stops are close only.

Flash Update: **Wednesday, July 26, 2000:**
Good morning for Wednesday July 26, 9:30 am. This is a Flash Update. We have sold short October crude oil at 27.73, placing our initial stop at 29.25, close only.

Flash Update: **Thursday, July 27, 2000:**
Good morning for Thursday, July 27, 11:00 am. This is a Flash Update. We have purchased December cotton at 60.63, placing our initial stop at 58.50. We have also rolled over our long gold position, selling October at 280, and buying December at 286.30.

Friday, July 28, 2000:
Good afternoon for Friday, July 28, 5:05 pm. The following is a recap of our current open position recommendations, and our latest stop levels: We are long October sugar, with our stop revised to 9.30; long September copper, with our stop at 82.50; short October crude oil, with our stop revised to 28.75; long December gold, with our new stop at 281; and long December cotton, with our initial stop at 58.50. All stops are close only.

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