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With consumption growing and production tilting downwards, gold prices are bottoming

The $40-per-ounce rally in gold prices this past spring faded as quickly as it happened (Chart 1). The move was triggered when a financially troubled Australian miner was forced to cover its hedges, which in turn sparked a broader short-covering rally.

The rally may have been short-lived, but it will take some time to shake off its effects. Commodity funds were heavily short gold earlier this year, but swung all the way to the other side during the rally. To illustrate, consider that CFTC data showed funds to be net short 58,133 contracts on April 10, just before gold prices started to inch up. The market then soared and peaked at $297 per ounce on May 21. By May 29, funds were net *long* 43,236 contracts. A liquidation phase ensued, and as of the most recent CFTC report, the funds had pared back their net long position to 10,602 contracts.

These are mammoth shifts and demonstrate quite clearly how movements in markets are often exaggerated by concentrated speculative activity. If we were to assume that a shift in the supply/demand fundamentals has occurred, it would be difficult to explain why the rally faded so rapidly.

Still, an argument can be made that things have changed in the gold market. The rally that wasn't may have been a harbinger of future rallies.

Central banks have been selling their gold because it provides only a meager return. This strategy has spilled over into the private sector and has reinforced the notion among investors that there are more profitable vehicles suitable for long-term investment. This, an 18-year bull market in equities, and an absence of inflationary fears have kept investment demand sluggish in recent years.

The one area that is probably in transition, though, is the equity factor. The bear market in the NASDAQ has certainly shaken confidence and sent investors in search of alternative investments. Although difficult to quantify, gold should begin to benefit from an adjustment to more traditional investments.

In sizing up the gold market from a strict commodity-style, supply/demand perspective, however, the potential for a turnaround may be more definitive. Jewelry demand tapered off in the wake of the Asian crisis towards the end of the 1990s. After a 17% increase in 1997 to 3,349 tonnes, jewelry consumption fell 6% in 1998 and again slightly in 1999. The year 2000 saw a small recovery. But according to the most recent report by the World Gold Council, demand in the first quarter grew 6% over the same period in 2000, to 734 tonnes, a record for the first quarter of the year. If jewelry demand, which represents about 80% of total gold consumption, is indeed bucking the trend of faltering demand for commodities, mine production would have to keep pace to ensure balance in the market.

Mine production grew throughout the 1990s but has been relatively flat over the past few years, averaging just over 2,500 tonnes. In its April report, Gold Fields Mineral Services (GFMS) reports that production costs continue to decline steadily each year. Average cash costs fell by $10 per ounce in 2000, to $186 per ounce. Total costs, declined as

In this issue

Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

well, to $238 per ounce, but with gold trading at $265 per ounce, profit margins are too slim to encourage new development. It is therefore difficult to envision an environment in which we will see the trend of no growth in mine output reverse any time in the foreseeable future. In fact, we could very well see production dropping.

South Africa remains the world's largest producer of gold, but its output has dropped each year since 1993. It mined 428 tonnes in 2000, 30% less than in 1993. South Africa is also the world's highest-cost producer, with cash costs of $221 per ounce and total costs of $240 per ounce. The primary reason for the declining output, however, is that many mines are mature and may not be economical to mine even with higher bullion prices. Although not quite as dramatic, the same trend is evident in Australia, Canada, and the US, where costs are higher and output has been lower or flat over the past few years. By contrast, production in low-cost, Third World countries, such as Indonesia and Peru, has grown.

As aging mines are put out of production, the single most important issue in the gold market becomes the rate at which economical mines can replace those that are shut down. The general feeling among analysts is that at present there is probably somewhat more production being shut down than new production coming on line.

Another factor resulting from a prolonged period of weak prices, which has provided price support and will gradually turn into a bullish factor, is the disappearance of producer hedging in 2000. GFMS estimates that the for the first time since it began tracking producer hedge books over 20 years ago, there was no increase in net hedging in 2000.

In conclusion, we believe that gold is forming a long-term bottom. We got our feet wet with a small long position and will be looking for evidence that the rate of mine closures is accelerating faster than new, low-cost output comes on stream. *[July 18, 2001]*

STRATEGY: *Remain long December gold as per flash update of July 9. Maintain initial stops at 252, close only.*

Chart 1 – Spot Gold

WHEAT

Summer rally or the real thing?

Was the rally in wheat a piggyback on the soybean rally, or does it have its own backbone?

On the surface, an argument can certainly be made that the rally did not stand alone. Summer growing weather in the US, which can be potentially hazardous to soybean and corn yields, is not nearly as important to wheat. More than 70% of the total crop is winter wheat, of which 80% has already been harvested. And dryness in the spring wheat regions seems to have been more detrimental to beans and corn.

Chart 2 shows a spread between Chicago (winter and spring) and Minneapolis (spring only) contracts. The chart shows that Chicago has gained more than 20¢ per bushel over Minneapolis during this run, indicating that the strength in prices was not directly related to issues with the progress of the spring wheat crop.

Yesterday's crop progress report showed that the good-to-excellent categories of beans and corn are 13 and 16 percentage points respectively below the same time last year, while the spring wheat crop is only 2 percentage points below last year's progress.

Furthermore, in marked contrast with beans and corn, commodity funds were net short wheat coming into the summer-weather-jitters season. We had to expect any rally to be exaggerated by short covering.

While there is little doubt that the rally in wheat was inspired in part by the rally in beans and corn – particularly because the feedgrain portion of the wheat market is governed by the corn/wheat ratio – a closer look at the action reveals independent strength in wheat. This is especially true when wheat is stacked up against corn as depicted in Chart 3. Soybean and corn prices have clearly benefitted from inclement weather and from robust overseas demand. But this is the point at which we feel wheat parts company with beans and corn.

We've focused on shrinking global output for as long as any reader of this letter can remember, and aside from the boredom we've surely generated, the attention we've devoted to this issue has not yielded many profitable trades. But the downward trend in production persists.

The 2001-02 crops of three of the four major exporters continue to falter. In its July supply/demand situation report, the USDA dropped the EU crop estimate to 96.14 million tonnes from 97.95 million tonnes. On July 16, French analyst Strategie Grains lowered the estimate further, to 93.8 million tonnes.

The Canadian crop, reported by the USDA at 25 million tonnes, did not take into account the dry weather being experienced across the Canadian prairies. The Canadian Wheat Board has since lowered its estimate for the Canadian crop to between 20.2 and 21.2 million tonnes.

Although the July USDA report revised the US crop upwards from the June report by 890,000 tonnes, we should not lose sight of the fact that it will still be 11% smaller than the 2000-01 crop.

Despite falling production, the July USDA report raised its forecast for 2001-02 global ending stocks by 730,000 tonnes, to 133 million tonnes, because of a 1.09-million-tonne upward revision to 2000-01 ending stocks, and a 1.2 million tonne downward revision to usage. As a percentage of consumption, stocks have risen only slightly, to 22.4% from 22.2% in June. When factoring in the between-session downward revisions to the EU and Canadian crops (2.34 million tonnes and at least 3.8 million tonnes respectively), however, ending stocks would actually fall to 126.86 million tonnes, or 21.4% of consumption. This would be the lowest estimate since the surprise addition of Chinese stocks in May altered the world ending stocks picture dramatically.

US exports have been fairly steady, averaging 494,000 tonnes the past 4 weeks compared with an average of 403,000 tonnes in the previous 4-week period. This indicates that rather than scaring buyers off, dearer prices have importers scrambling to meet their needs. Specifically, in the past few days, some EU countries, which typically meet their needs from other EU countries with surpluses, have either purchased, or are rumored to be in the market for, US wheat. This is highly unusual and provides anecdotal evidence that the era of complacency that facilitated hand-to-mouth purchasing patterns in recent years may be over.

[July 24, 2001]

STRATEGY: *Remain long September wheat as per Flash Update of July 20. Maintain stops at 250, close only.*

Chart 2 – Chicago Wheat/Minneapolis Wheat

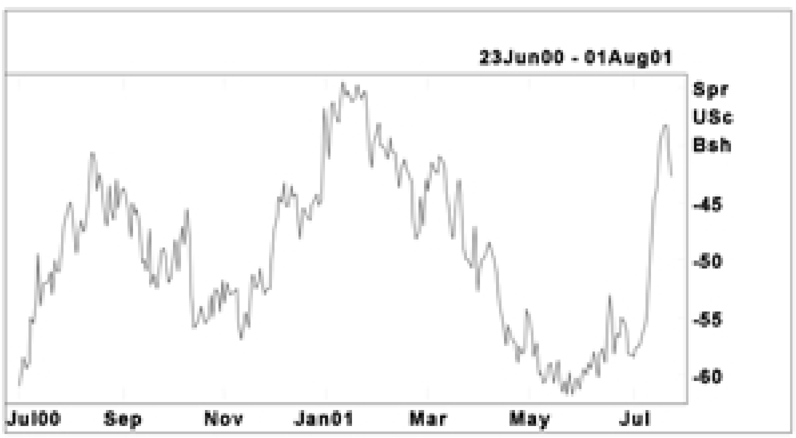

Chart courtesy REUTERS

Chart 3 – Wheat/Corn

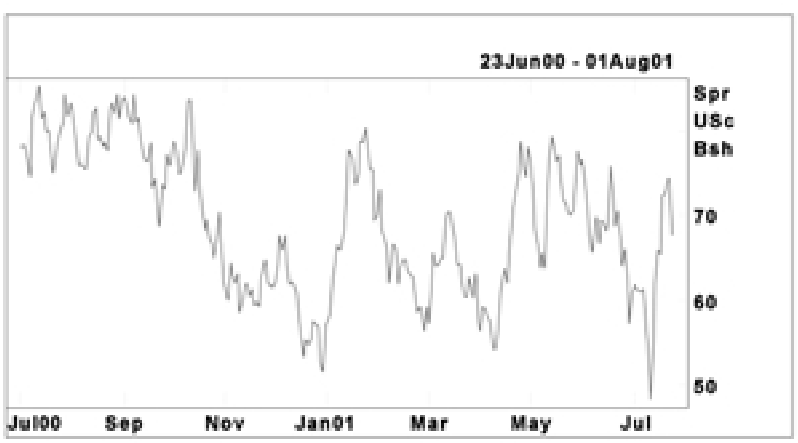

Chart courtesy of REUTERS

SOYBEANS

Reflecting on the pause in the rally

Two overwhelmingly bearish supply-side factors pushed soybean prices close to $4 per bushel earlier this year.

First, we faced record crops in South America. Forecasts for the size of Brazilian and Argentinean crops increased every month throughout the growing season. The July USDA supply/demand situation report estimates that combined output from the two countries grew by 8 million tonnes, a staggering 15% more than the 1999-00 crop.

Then there was the US summer crop to deal with. Farmers were expected to increase soybean planting by more than 2 million acres, to 76.93 million acres, or 3%, over 2000-01.

The South American factor would still be a drag on the market were it not mitigated by bullish developments with the North American factor. The June 29 USDA acreage report showed that analysts were way off the mark with this one. Soybean acreage came in at 75.4 million acres, 1.53 million acres less than the average estimate. Using what now looks like a very optimistic yield of 39.5 bushels per acre, this lopped 1.36 million tonnes off previously estimated output.

A 400,000 tonne reduction in beginning stocks and a 850,000 tonne increase in domestic and export demand in the July 11 USDA report combined to slash the forecast for 2001-02 ending stocks by about 2.6 million tonnes from the June estimate, to 9.38 million tonnes, or 12% of consumption. This compares with the USDA's first estimate in May of 2001-02 ending stocks of 13.62 million tonnes, or 18% of consumption.

To put things in chronological perspective, according to the July 11 report, the US still had ample supply relative to the previous two seasons. Ending stocks for 2000-01 were 6.93 million tonnes, or 9% of consumption, and 7.9 million tonnes for 1999-00, or 10.6% of consumption. But the situation has changed. The July 11 report certainly did not account for potential damage to the 2001-02 crop and the impact it would have on ending stocks.

Since the July USDA report, we have had on-again/off-again hot-dry weather forecasts. This past Monday's crop progress report showed the good-to-excellent portion of the crop fell further, to 55% from 57% a week earlier and from 68% at the same time last year. Indeed, well regarded analysts have put specific numbers to the damage. *Oil World* puts 2001-02 ending stocks at 7.5 million tonnes, or 9.6% of consumption. Iowa State Ag Economists have taken a far more aggressive stance and estimate that the inclement weather will cut yields to 37.5 bushels per acre, producing a crop of only 75.91 million tonnes compared with the USDA estimate of 79.88 million tonnes. Ending stocks in this model will fall to 5.39 million tonnes, or 7% of consumption!

We could safely assume that the revised ending stocks estimates – both the radical and more moderate ones – are not a secret. This seems to imply that the deterioration of crop conditions in the past few weeks may be "in the market." In fact, prices are now back to where they settled on July 11, the day of the USDA report.

The market is not necessarily overextended if the weather does not improve. However, the most recent commitment of traders report shows huge net long positions for both commodity funds (43,819 contracts) and small speculators (25,395 contracts). The open interest has dropped some 13,000 contracts over the past week or so but is still rather high historically.

US export commitments have improved during the meat of the rally, averaging 505,000 tonnes over the past 4 weeks, compared with only 318,000 tonnes in the previous 4-week period. One of the key items to watch for in the coming weeks is how overseas importers react to these prices. On the other hand, until the Brazilian and Argentinean crops are sold out, it could be forgiveable if US exports remain soft until the new crop is harvested.

In conclusion, with world demand as strong as it is, this market has potential. Although the US crop may still be of record size, the market continues to come to terms with disappointing acreage. We're friendly and looking for an opportune moment to hop on. *[July 26, 2001]*

STRATEGY: *Remain sidelined, but stay tuned.*

OIL

OPEC cuts output in desperation – but will it work?

OPEC ministers were scheduled to meet in early August – an exact date had not been set – to decide if they would cut production for a third time this year to halt the slide in oil prices. Nigeria's oil minister, Rilwanu Lukman, said just this past Friday, "As long as the price is in the band ($22 - $28), we are reasonably happy." However, just a few days ago the price of the OPEC crude basket was quoted as low as $22.64 per barrel, and the pressure proved too much to handle. In a hastily arranged conference call on July 25, the ministers agreed to cut output by 1 million barrels a day, to 23.2 million barrels per day (bpd), effective September 1.

As prices approached the bottom end of the OPEC band, the market expected the cartel to act, and consequently there was no element of surprise in the move. Anticipation of the cut had already caused prices to firm significantly in the days leading up to the impromptu mini-conference, with a rally of about $2 per barrel.

Petroleum prices have been falling because weaker economies around the globe have been generating less demand. Identifying a long-term formula that will stimulate demand would probably be the best way to stabilize prices. Creating an environment that will push prices higher, then, can hardly be part of a successful strategy to generate demand.

Many economists are talking about a brighter outlook for slouching economies, but we're not out of the soup yet. This morning, US GDP figures were released, showing that the economy of the world's largest importer of oil grew only 0.7% in the second quarter, below economists expectations of 0.9%.

Given this dilemma that OPEC and other oil producers face, we question OPEC's ability to push prices back up to the top end of the band while consumption patterns are already flat to slightly negative.

This production cut also comes at a time when there has been a formidable buildup of stocks of crude and products in the US. According to The American Petroleum Institute's (API) statistics, crude oil stocks, even after a setback over the past few weeks, have increased by 39 million barrels, or 14%, since late spring. Stocks have not been this plentiful since the summer of 1999.

A few months ago the market was expecting a very busy driving season. Prices of unleaded gas went through the roof, spiking to $1.17 per gallon. The market, however, overestimated demand, and prices have dropped dramatically. Stocks have increased by 24 million barrels in the past few months. Chart 4 shows that a buildup in gasoline stocks at this time of year is counter-seasonal. In each of the past five years, gasoline stocks have fallen from mid-year through the end of the summer. Like crude stocks, gasoline stocks are now back to the level they were at in mid-1999. We are still in the middle of the summer driving season, and with prices at the pump falling to more reasonable levels, we can probably expect to see some drawdown from here. Even so, supplies are ample, and we are nowhere close to the shockingly low inventory levels that drove prices earlier this year.

The headlines certainly have the power to drive prices higher for a while. But compliance among OPEC members is crucial, and their track record is less than stellar in that department. According to Bloomberg estimates, even before this week's OPEC action, the member countries were producing 24.78 million bpd, 579,000 bpd above the allotted quotas.

With commitment of traders data showing commodity funds and small speculators net short a combined 66,725 contracts, it was clear that one way or the other, we were going to have a short-covering rally regardless. The OPEC event was merely the catalyst. Until demand recovers, we believe that prices in the petroleum complex will behave like any ho-hum industrial commodity and work their way lower. *[July 27, 2001]*

STRATEGY: *Remain short September crude oil. Maintain initial stops at 27.75, close only.*

Chart 4 –
API Gasoline Stocks

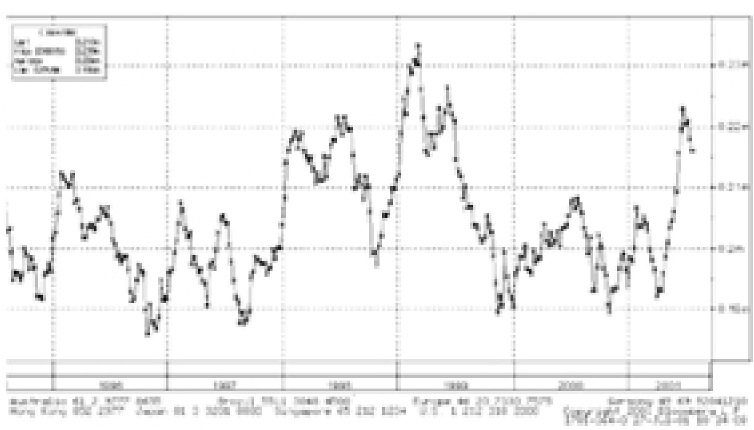

Chart courtesy Bloomberg

HOTLINE UPDATE

***Flash Update* – Monday, July 2, 2001:**
Good morning for Monday, July 2, 10:10 am. This is a Flash Update. We have liquidated our long October sugar position at 8.87.

***Flash Update* – Monday July 2, 2001:**
Good afternoon for Monday July 2, 1:30 pm. This is a Flash Update. We have purchased September cocoa at 974, placing our initial stop at 904, close only. We repeat our Flash Update of this morning, where we liquidated our long October sugar position at 8.87.

Friday, July 6, 2001:
Good afternoon for Friday, July 6, 5:05 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short September mini S&P, with our stop at 1285, and long September cocoa, with our initial stop at 904. All stops are close only.

***Flash Update* – Monday July 9, 2001:**
Good morning for Monday, July 9, 9:30 am. This is a Flash Update. We have purchased September wheat at 267.50, placing our initial stop at 250, close only.

***Flash Update* – Tuesday, July 10, 2001:**
Good afternoon for Tuesday July 10, 1:30 pm. This is a Flash Update. We have liquidated our long September cocoa position at 904.

***Flash Update* – Thursday, July 12, 2001:**
Good afternoon for Thursday, July 12, 2:00 pm. This is a Flash Update. We have liquidated our long September wheat position at 287.75.

***Flash Update* – Friday, July 13, 2001:**
Good afternoon for Friday, July 13, 4:00 pm. This is a Flash Update. We have covered our short mini S&P position at 1220.75.

Friday, July 13, 2001:
Good afternoon for Friday, July 13, 5:10 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are long December gold with our stop at 252. All stops are close only.

***Flash Update* – Wednesday, July 18, 2001:**
Good morning for Wednesday, July 18, 10:00 am. This is a Flash Update. We have sold short September mini S&P at 1209, placing our initial stop at 1230, close only.

***Flash Update* – Friday, July 20, 2001:**
Good morning for Friday, July 20, 10:05 am. This is a Flash Update. We have purchased September wheat at 289, placing our initial stop at 250, close only.

Friday, July 20, 2001:
Good afternoon for Friday, July 20, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December gold with our stop at 252, short September mini S&P with our initial stop at 1230, and long September wheat, with our initial stop at 250. All stops are close only.

***Flash Update* – Tuesday, July 24, 2001:**
Good afternoon for Tuesday, July 24, 9:15 am. This is a Flash Update. We have sold short September crude oil at 26.08, placing our initial stop at 27.75, close only.

Friday, July 27, 2001:
Good afternoon for Friday, July 27, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long December gold, with our stop at 252; short September mini S&P, with our stop at 1230; long September wheat, with our stop at 250; and short September crude oil, with our initial stop at 27.75. All stops are close only.

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Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1910
New York, N.Y. 10005
(212) 943-5300