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Even bullish news can't inspire cocoa prices

Despite the appearance of a fairly steady stream of bullish supply-side news, the bull run in cocoa prices has not been able to regenerate itself. September cocoa rallied $250 per tonne from its $1,420-per-tonne low – set on June 2 – but has now given back those gains and is trading just shy of the lows (Chart 1).

The most prominent bullish development was a sharp reduction to the estimate of the 2002-03 Indonesian crop, previously believed to be as high as 485,000 tonnes. Last week, press reports indicated that widespread pest infestation on Sulawesi Island – where 75% of Indonesia's cocoa crop is grown – has reduced the size of the crop dramatically. Some forecasters are slashing their estimates for the crop by as much as 100,000 tonnes, large enough to mitigate the unexpectedly strong Ivorian crop and singlehandedly eliminate the anticipated global production/consumption surplus.

Ivorian output for 2002-03 tied record levels, but the early going for the 2003-04 season does not look quite as promising. The first half of July saw insufficient precipitation, which could hamper the development of the new main crop. In addition, harvesting of the very successful 2002-03 mid-crop extended beyond the normal time frame and could put a strain on the new main-crop.

On the other hand, it is a bit early in the season to be too concerned, because there is ample time for the weather to improve. Besides, high prices received by farmers over the past year have allowed them to invest in crop-enhancing materials. In the Ivory Coast, sales of fertilizer and pesticides have doubled, creating shortages in some areas. If the weather behaves reasonably, the Ivory Coast will probably put in another stellar performance in 2003-04.

To keep the bull market alive, though, the demand side must participate, and there is little evidence of this happening yet. Second-quarter grind data have been disappointing thus far. After a surprisingly higher-than-expected increase in German grindings of 12.7% and an uptick in butter ratios in most regions, the market was looking for an equally robust number for the pan-European grind, which covers 95% of Western European activity, including Germany. But Germany represents less than 20% of grinding activity in Europe, and it was the only pocket of strength. The pan-European grind came in only 2.6% higher than the second quarter of 2002.

A similar pattern has emerged in Asia where Chinese grinding activity has been subdued, even though butter ratios have been firming, which would normally make processing profitable. Ratios have moved up from 1.5 times the price of beans on the London Commodity Exchange several months ago to 1.75 in China and 1.8 in Southeast Asia.

An increase in the level of the butter ratio is ultimately an important bullish factor, but the levels have obviously not been high enough to inspire a significant increase in grindings. Interestingly, as we reported last month, butter ratios in Germany have been hovering at around 2, and indeed its grind was the strongest among the major grinding countries.

Our general outlook for this market remains bearish. We are still reeling from the Ivory Coast situation. Not so much that the country was able to produce a bumper crop in the midst of a treacherous civil war, but from the fact that the information available to the public – including sophisticated Western analysts who maintained much lower forecasts until final arrival data indicated that there was virtually no effect on output – could be so inaccurate. We believe that the market is still adjusting to the disinformation about the Ivorian crop. As mentioned earlier, however, the revisions to the Indonesian situation probably neutralize the increased supply

Inside

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

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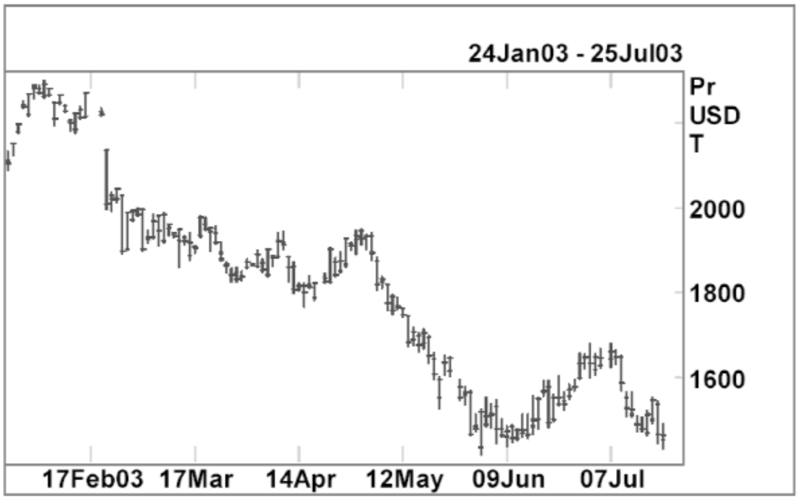
from the Ivory Coast, so it is difficult to build a very bearish case on the supply side.

It is disappointing for bulls that recovery in demand has been slow. Although this is the third consecutive quarterly increase in the pan-European grind after six consecutive decreases, the improvement is only moderate and certainly less than bulls were looking for in 2003.

Having missed a series of glorious opportunities to catch the unwinding of this bull market, we will stand aside for the time being. *[July 22, 2003]*

STRATEGY: *Remain sidelined.*

Chart 1 – September cocoa



Courtesy Reuters

CORN

Sinking prices defy long-term bullish picture

The July USDA supply/demand situation report contained several bearish revisions to the corn picture, which drew further selling to a market that was already tumbling. September corn traded at new contract lows this week (Chart 2). The most significant item contained in the report was a 5.3-million-tonne upwards revision to the 2003-04 US crop. Excellent growing conditions prompted the USDA to raise its yield estimate by 3 bushels to a record 142.7 bushels per acre, which would bring in a record crop of 261 million tonnes. If this forecast proves to be sustainable, it would difficult to "argue" with the market. After all, the US grows about 40% of the world's corn supplies, and its exports account for over half of world trade. Such a large crop should handily accommodate both domestic and foreign requirements.

Market participants, however, are focusing all their energy on the progress of the US crop. We believe that there are other factors to consider.

US exports in 2002-03 were absolutely pathetic. At just over 40 million tonnes, foreign shipments will be the smallest they've been since the1997-98 season when the Asian crisis hit. For the four years in between, exports were on average 23% higher – at close to 50 million tonnes.

The USDA's early forecast for 2003-04 of 47 million tonnes may be a bit on the conservative side. There is reason to assume that exports should return to normal levels. Aside from Argentina, other exporting countries – there are not that many – are expected to have smaller crops this year. China's 118-million-tonne crop, as we discussed last month, will allow it to continue exporting, but not anywhere near the 13.5 million tonnes it sold in 2002-03. Brazilian output will drop sharply, to 37.5 million tonnes, from 43.5 million tonnes last year.

An important structural change in domestic US consumption is the advent of a commercially viable corn-based fuel market. While in the past we viewed forecasts for any significant impact on corn consumption to be somewhat futuristic, a more careful examination of the facts shows that the amount of corn used to manufacture ethanol is indeed growing rapidly. The USDA estimates that 28.6 million tonnes of corn will be consumed as ethanol in the 2003-04 marketing year. This is 18% higher than in 2002-03 and double the amount used in the 1999-00 season. Ethanol consumption now represents 11% of all the corn grown in the US, compared with only 6% in 1999-00. In 1999-00 ethanol accounted for only 7.4% of domestic usage, while in 2003-04 it is expected to comprise 13.8% of domestic demand. These figures are obviously included in the current estimates, and the market does not seem intimidated by them. But if demand for ethanol continues to grow at this pace, it will cut into the availability of corn for the export market.

The USDA raised its forecast for 2003-04 global ending stocks by 2.2 million tonnes over last month's estimate, mostly on account of the increase in the estimate for the US crop. In real terms, however, the increase was relatively small because there was also a 2.7-million-tonne increase in the forecast for global consumption. Stocks as a percentage of consumption moved up to 13.4% from 13.1%. Despite the upwards revision, ending stocks remain the lowest in history. Even including last season's 15.3%, average global ending stocks as a percentage of consumption for the past 5 years was 23.8%.

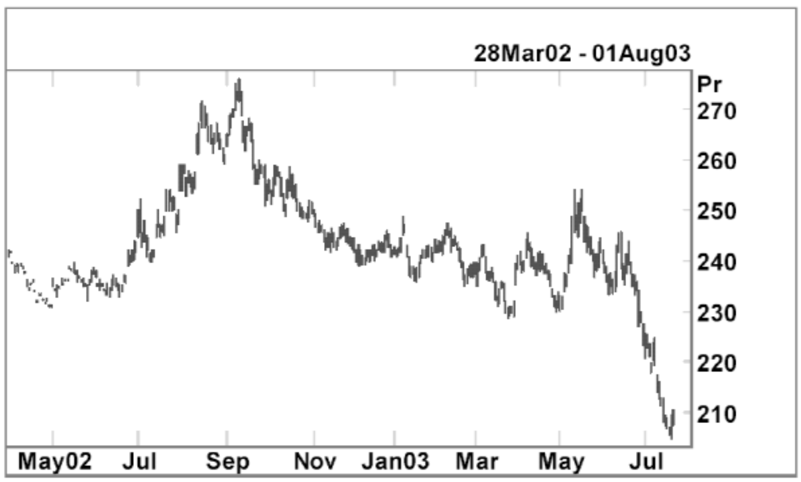
Many argue that we cannot justifiably compare ending stocks to other eras, because foreign purchasers have adopted different standards for their inventory levels. Living hand-to-mouth has become acceptable as users have become complacent with more efficient world trade. Which is fine as long as there are no surprises.

Commodity funds have moved from a massive net-long position of 73,000 contracts to a massive net-short position of 45,000 contracts as of this past Friday's Commitment of Traders report. Sentiment readings are very low. Any trace of something-can-still-go-wrong premium has been squeezed out of the market. While the US corn crop is almost "made," it is still a tad early to throw caution to the wind. Monday's weekly crop progress report was a bit of a surprise with the good-to-excellent portion of the crop dropping 2 percentage points to 72%.

All of which leads us to believe that the market is very oversold. We are probably early, but given our strong belief in the existence of long-term bullish fundamentals, we are taking a stab at the long side. *[July 24, 2003]*

STRATEGY: *Buy December corn at the market. Place initial stops at 208, close only.*

Chart 2 – September Corn



Courtesy Reuters

COTTON

Expected softening of Asian demand has not yet arrived

After closing at new contract highs two weeks ago, cotton prices have retreated, moving against developing bullish fundamentals. In stepping back and looking at the bigger picture, it can be argued that the rally to the 60¢-per-pound level already represents an adjustment from the 28¢-per-pound level touched in the autumn of 2001, commensurate with the dramatic shift in fundamentals that has occurred since then (Chart 3). A surge in global output in the 2001-02 season, allowed storage bins to overflow, causing a global glut of cotton that pushed ending stocks above 50% of consumption. The entire process has been reversed, though, and the question we face is whether the adjustment in price is complete.

The primary concern for bulls is China, on both the supply and demand sides. Chinese farmers are set to harvest a huge crop of 27 million bales in September, 4.4 million bales, or about 20%, larger than the 2002-03 season. This will be the biggest crop in 12 years.

In its July supply/demand situation report, the USDA raised its forecast for 2003-04 domestic demand by 1 million bales, or 3.5%, to 29.70 million bales. The estimate for imports was kept at 2002-03 levels of 2.6 million bales. This was quite a leap from previous years in which China was an insignificant importer of cotton. As recently as the 2001-02 season, Chinese imports represented only about 1.5% of world trade, compared with 2002-03 when that figure jumped to 9%.

Issues surrounding SARS – quite logically – were anticipated to have cut into demand for cotton in Asia (see *Focus on Futures*, May 21). This is prompting some industry analysts to question the USDA's optimistic forecast for an increase in Chinese cotton demand. With such a jump in output and the possibility of a softening in consumption, the USDA's estimates for China may be unrealistic. Sales to China in 2002-03 comprised 15% of US exports. Losing any substantial part of this business puts a crimp in the whole bullish case, which is based in no small part on very strong US exports.

These are clearly coherent arguments, but not insurmountable ones. Over the years, rather than entering the import market, the Chinese chose instead to reduce their massive inventories. A combination of meeting WTO guidelines and the fact that stocks have been run down pushed China to purchase foreign cotton this past season. These factors are still present. As the 2002-03 marketing year comes to a close, Chinese cotton stocks of 8.61 million bales stand at a low in modern history, representing 30% of consumption. This compares with inventories at the end of the 1998-99 season when stocks peaked at close to 90% of consumption.

Furthermore, the hard evidence resides in the bull camp. There is absolutely no indication that there has been any let up in the torrid pace of US exports. Export commitments are now running about 500,000 bales ahead of the same time last year and well on their way to meeting the USDA's estimate for the final tally of 11.6 million bales of shipments. Specifically, US exporters have actually shipped close to 95% of Chinese commitments. Among other Asian countries in the region, Japan, Taiwan, and Hong Kong have received 87%, 86%, and 96% of their commitments respectively. There has been ample time for SARS to have reared its head in cotton consumption as it has in other industries, both in China and in other countries such as Canada. Chinese government customs data, which show that cotton imports from January to May have surged, corroborates the US export figures.

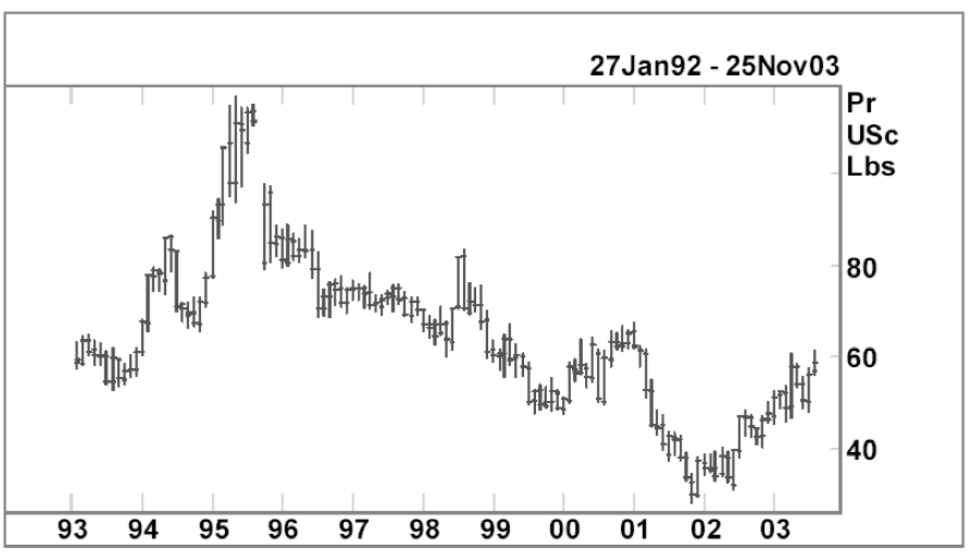
Commodity funds have swung to the long side, and the recent slide in prices may very well represent some liquidation after technically oriented traders became disappointed with the market's failure to take out last spring's highs convincingly. This week's export data were very strong, with combined old- and new-crop sales of 283,000 bales, ridiculously higher than the street's estimate of 50,000-100,000 bales. At 315,000 bales, shipments were particularly strong, and with only a couple of weeks left to the marketing year it leaves the USDA target just a smidgeon away. The market took its cue from these export figures and staged a rally to recoup almost all of this week's losses.

Have these relatively rich prices already accounted for the bullish fundamentals? Global ending stocks for 2003-04 continue to be revised downwards every month. They now stand at 33.2% of consumption, compared with 37.7% at the end of 2002-03. When we were at these levels in the mid-1990s, the market soared to well over $1 per pound. As we pointed out in this week's article on corn, it is difficult to compare ending stocks of different eras. Still, we are monitoring the situation carefully to determine whether US exports are sustainable. If they are, the global supply/demand balance will continue to tighten, and the market can indeed burst through the highs.

[July 25, 2003]

STRATEGY: *Stay closely tuned.*

Chart 3 – Nearest contract cotton



Courtesy Reuters

WHEAT

Export talk and nervousness about key producing countries sets prices on a tear

Wheat prices this week sprinted to highs not seen since last fall. A series of bullish supply-and-demand-side items prompted the rally. Can these prices be maintained and built upon? Clearly, this was an independent wheat affair and cannot be attributed to spillover from the corn or soybean pits. They were busy making multi-month lows this week.

On the demand side, there was talk about pending Egyptian purchases. There was a fair bit of fanfare surrounding a US visit by officials of Egyptian flour-milling concerns, complete with a press conference. They talked about returning to the US market in the 2003-04 marketing year after meeting most of their 2002-03 wheat requirements with European and FSU purchases. In 2001-02, Egypt was the largest buyer of US wheat, importing 3.8 million tonnes, or about 15% of all US sales. In 2002-03 Egyptian purchases dropped to 1.1 million tonnes, which alone was responsible for the drop in total US exports from 26.2 million tonnes in 2001-02 to 23.41 million tonnes in 2002-03. Having illustrated the importance of Egypt as a customer of US wheat, it is not difficult to understand the rally.

It was disappointing, then, when Thursday's weekly export report was rather lame. Commitments of 375,000 tonnes were well below the low end of analysts' expectations of between 500,000 and 700,000 tonnes, with no sales to Egypt at all. The weekly tally was also substantially below the 600,000-tonne average of the previous 4 weeks. The market remained fairly strong in the face of this news, consolidating the gains and awaiting further direction.

The supply-side news was rather constructive for prices as well. After a fairly decent season thus far for the spring wheat crop, some hot and dry weather emerged in the Northern Plains. The same weather system is affecting parts of the Canadian wheat-growing regions as well. Major exporters Australia and Canada grew abysmal crops in 2002-03 (9.4 vs. 24.85 million tonnes in 2001-02 and 15.7 vs. 20.6 million tonnes in 2001-02 respectively). The last thing you'd want to hear is that any of these countries, which along with the US are suppliers of milling grade food wheat, are having trouble with their crops. This was expected to be a recovery year.

The Australian crop was planted late in many regions, and local forecasters are looking at a harvest of between 1 million and 2 million tonnes below the USDA's July estimate of 23 million tonnes. It's early in the growing season, which still leaves the crop vulnerable to weather.

There have not been any extraordinary crop problems in any of the major producing nations, but any hint of trouble can make traders nervous.

In itself, the July USDA supply/demand situation report was quite bearish. The estimate for 2003-04 global production was lowered by just over 1 million tonnes, to 560.3 million tonnes. Consumption, however, was slashed by close to 6 million tonnes, resulting in a 3.7-million-tonne increase in ending stocks. The July carryover jumps to 24% from 23.2% of consumption in June.

The market, however, seems to be focusing on the bigger picture. Last year's ending stocks were 27.5% of consumption, and 2001-02 finished at 34% of consumption. We are now heading into the sixth consecutive year of declining global wheat production. After surviving last year's crop failures, the market dropped dramatically by about $1.50 per bushel from the spike to $4.40 per bushel. The selloff was obviously overdone. As illustrated, global inventories are still falling. On the surface, stocks levels of 24% of consumption do not seem to represent a very tight market. But global carryover stocks have not been anywhere near this low since the devastating US drought of 1988.

In conclusion, the Egyptian purchases haven't materialized as of yet, but they probably will. Although the US dollar has been falling since the beginning of 2002, most of the decline occurred after Egypt planned its 2002-03 import needs. While this is not a forum for currency forecasts, we can safely say that the dollar remains weak. Certainly in the case of competition from European countries, this will be a significant factor, as US wheat is priced back into the market.

Our track record in trading wheat is not great. It's not even good. We maintain a strong long-term bullish bias, but we're not about to chase a 50¢-per-bushel rally. We will, however, be vigilantly waiting for an opportunity to get long.

[July 25, 2003]

STRATEGY: *Stay tuned.*

HOTLINE UPDATE

***Flash Update* – Thursday, July 3, 2003:**
Good afternoon for Thursday, July 3, 2:10 pm. This is a Flash Update. We have liquidated our long November soybean position at 547.

Thursday, July 3, 2003:
Good afternoon for Thursday, July 3, 2:50 pm. The following is a recap of this last week's trade recommendation history and our latest recommendations and stop levels: On July 3 we liquidated our long November soybean position at 547. We do not currently have any open positions.

***Flash Update* – Wednesday, July 9, 2003:**
Good afternoon for Wednesday, July 9, 3:20 pm. This is a Flash Update. We have purchased September Japanese yen at 8510, placing our initial stop at 8350, close only.

***Flash Update* – Friday, July 11, 2003:**
Good afternoon for Friday, July 11, 3:30 pm. This is a Flash Update. We have purchased September 10-year Notes at 117-015, placing our initial stop at 115-30, close only.

Friday, July 11, 2003:
Good afternoon for Friday, July 11, 4:20 pm. The following is a recap of this last week's trade recommendation history and our latest recommendations and stop levels. On July 9 we purchased September Japanese yen at 8510; on July 11 we purchased September 10-year Notes at 117-015; we are currently long September Japanese yen at 8510, with our initial stop at 8350; and long September 10-year Notes at 117-015, with our initial stop at 115-30. All stops are close only.

***Flash Update* – Tuesday, July 15, 2003:**
Good afternoon for Tuesday, July 15, 3:10 pm. This is a Flash Update. We have liquidated our long September 10-year Notes position at 115-01.

***Flash Update* – Thursday, July 17, 2003:**
Good morning for Thursday, July 17, 9:40 am. This is a Flash Update. We have sold short September mini S&P at 992.25, placing our initial stop at 1015, close only.

***Flash Update* – Thursday, July 17, 2003:**
Good afternoon for Thursday, July 17, 3:25 pm. This is a Flash Update. We have liquidated our long September Japanese yen position at 8433. We repeat our update of this morning where we sold short September mini S&P at 992.25, placing our initial stop at 1015, close only.

Friday, July 18, 2003:
Good afternoon for Friday, July 18, 4:10 pm. The following is a recap of this last week's trade recommendation history and our latest recommendations and stop levels: On July 15 we liquidated our long September 10-year Notes position at 115-01; on July 17 we sold short September mini S&P at 992.25 and liquidated our long September Japanese yen position at 8433; we are currently short September mini S&P at 992.25, with our initial stop at 1015. All stops are close only.

***Flash Update* – Wednesday, July 23, 2003:**
Good morning for Wednesday, July 23, 9:20 am. This is a Flash Update. We have purchased December gold at 352.40, placing our initial stop at 330, close only. We have also purchased December corn at 213.5, placing our initial stop at 208, close only.

***Flash Update* – Friday, July 25, 2003:**
Good afternoon for Friday, July 25, 4:05 pm. This is a Flash Update. We have covered our short September mini S&P at 997.25.

The following is a recap of this last week's trade recommendation history and our latest recommendations and stop levels: On July 23 we purchased December gold at 352.40 and December corn at 213.5; on July 25 we covered our short September mini S&P position at 997.25; we are currently long December gold at 352.40, with our stop revised to 350; and long December corn at 213.5, with our initial stop at 208. All stops are close only.

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