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Friedberg Mercantile Group Ltd.



Volume 7, No. 6 July 5, 2004

Lots of cocoa, yes, but is it enough to meet demand?

On June 8, cocoa prices gapped above the trading range of the previous two sessions after news wire reports of renewed tensions in the Ivory Coast. The market closed up \$26 per tonne for the day, but sharply below the session's best levels. After years of political unrest in which the country managed to grow, harvest, and export normal-size crops, it should be difficult to sustain rallies that are inspired solely by reports of tensions in the Ivory Coast. While the possibility of supply interruptions may exist until a permanent political solution is achieved, history has proven that it is not a realistic concern at this time.

The high of that early June session established a near-term resistance level, and – for the most part – the market has been trending downwards. Without benefit of news of any fresh flareups in the Ivory Coast, all rally attempts have been pushed back. While rallies have not followed through, neither have attempts by commodity funds to break the market below the \$1,320-per-tonne support level. Commodity funds hold a substantial net-short position, and if they do not succeed in breaking the market, the current tight range will be resolved to the upside. Although, this will not provide grounds for a longer-term bullish view, we do maintain a bullish bias for cocoa prices.

The supply side continues to look strong. As of May 31, Ivorian arrivals reached 1.27 million tonnes. It is not clear how much of this includes mid-crop beans, but it is safe to say that with several months left to the mid-crop season, output will easily surpass E.D. & F. Man's March estimate for the 2003-04 Ivorian crop estimate of 1.3 million tonnes.

The world's second-largest producer, neighboring Ghana, is expected to produce a very robust crop of close to 600,000 tonnes, 20% larger than 2002-03 output. It seems fairly clear that included in this Ghanaian figure is a sizeable chunk of Ivorian beans smuggled across the border by Ivorian farmers seeking higher prices in Ghana. This means that the actual Ivorian crop was even higher than indicated by arrival figures, which is significant because it

dispels any notion that the output potential of Ivorian trees is waning.

So against a backdrop of a bearish supply side and despite the best efforts of commodity funds to penetrate the bottom of the range, this market has made no downside progress. In fact, a glance at Chart 1 shows that prices are at the same level that they were one year ago. The only possible explanation can be found in a stronger-than-expected consumption side.

In July, we'll get a look at the demand side of the balance sheet with the release of US and European grinding statistics. Most analysts are working with an annual growth rate of between 3% and 5%. There is not much consumption information available on a regular basis, but what evidence does exist shows healthy demand, which could mean that in reality, grindings are growing faster than believed, particularly in origin countries.

Brazil is the world's fourth-largest grinder, representing only 7% of global grindings. Grindings increased by 6.2% for the local 2003-04 crop year, which ended in April.

Inside

Sugar: Transition from surplus to deficit.....	2
Corn: Can bumper US crop replenish inventories?	3
Soybeans: Explosive growth sends bull home	5
Hotline Update	6

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Unlike the other principal grinding countries, Brazil publishes monthly statistics, which show that since January, grinding activity grew by a monthly average of 8.7%. In May, the most recent reporting period, grindings grew by only 1.5%, the smallest increase this year. The next monthly report should be released during the first week of July and gives us something to look for in a market that is otherwise short on timely data.

As small a player as Brazil may be, it is representative of the growth of the processing industry in origin countries. Evidence of how profitable grinding has become is the fact that Brazil produced only 153,000 tonnes of cocoa in 2003-04, but imported enough beans to grind over 200,000 tonnes. Similarly, Malaysia, which has been dropped off the list of major producers altogether, harvesting a paltry crop of less than 40,000 tonnes, ground 190,000 tonnes of beans into products during the 2003-04 season.

Butter ratios have moved to record highs with butter trading in Asia at about 2.4 times the front month at the

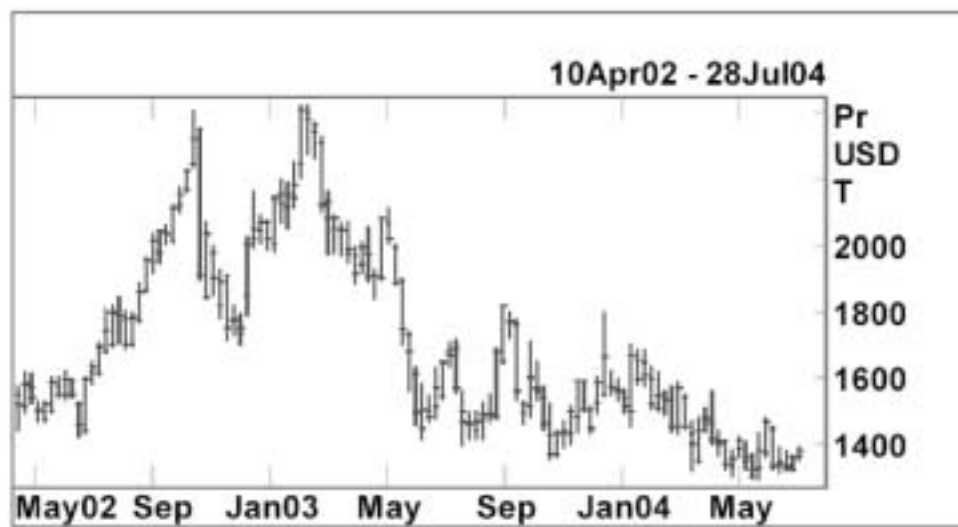
London Commodity Exchange. At first it seemed that the spike would be a short-term blip, but the ratio has been maintaining this level for many months now, a clear indication that butter stocks are being run down and end users are willing to pay up for spot supplies.

Certainly, if we view this market through Man's March estimate for a 41.4% global stocks-to-consumption ratio, it would be only a matter of time until prices begin to slide. As illustrated, however, consumption has remained strong enough to support prices and form a one-year-old base.

The market has been pushing up against the top end of the near-term range over the past few sessions. We believe that we are on the verge of a rally that will send shorts scrambling for cover – initially. If the above assumptions regarding the demand side prove to be accurate, the short-covering rally will turn out to have been merely the trigger for a much broader and long-term bull run. [July 1, 2004]

STRATEGY: *Stay tuned.*

Chart 1 – Weekly cocoa, nearest contract



Courtesy Reuters

SUGAR

Transition from surplus to deficit

Sugar prices have been firming steadily and are now trading at 2-year highs as they approach the 8¢-per-pound level. As we illustrated in recent issues, the rally was commensurate with the equally steady revisions to the 2003-04 global supply/demand balance, from early estimates of burdensome surpluses to a near balanced market.

As we look ahead to the 2004-05 crop year, indicators

remain bullish, but it is early. On June 22, The International Sugar Organization (ISO) revised its May forecast that called for a deficit of 3 to 4 million tonnes to a deficit that could be as large as 5 million tonnes. This compares with ISO's 2003-04 estimate of a small surplus of 225,000 tonnes and a 6.9-million-tonne surplus in 2002-03. The ISO estimates are rather loose, however. In its report, the ISO warned that its out-

look hinges on whether Brazilian output continues to grow at the torrid pace we've seen over the past several seasons, in which case the surplus would be only 2.5 million tonnes.

The cautionary tone attached to ISO's bullish report is in line with early private forecasts for the upcoming Brazilian crop. Based on estimates of free land available for sugar planting, output could grow by close to 2 million tonnes, or about 7%.

Turning to the demand side and updating the ethanol component, we find some interesting developments. Aside from Brazil, where commercial and private usage is well entrenched, other countries are creating infrastructures that will devote sugar resources to viable commercial ethanol usage sooner rather than later.

The Australian government, for example, recently earmarked substantial grants for ethanol projects that will be used to build construction facilities. As well, the provincial Queensland government will convert its entire 13,000 vehicle fleet into ethanol-consuming cars and trucks. The government's objective is very specific. Over the past decade, world sugar prices have been trading at levels that leave cane farming in Australia unprofitable. About 75% of annual output is shipped abroad. The government hopes that its intervention will reduce the industry's reliance on the export market.

Thailand imports over 90% of its petroleum needs. To curb its dependence on foreign oil, it too has been looking seriously at alternative fuel solutions. The government has a specific target of requiring all gasoline sold in the country to contain 10% bio-fuel by as soon as 2006. As it is, the new Thai crop is expected to be about 7% below last year's, because of drought.

Thailand and Australia are the world's second and third-largest sugar exporters and the principal suppliers to the Asian arena. Combined, the two countries make up 20% of world trade. If their bio-fuel programs unfold as planned, there will no doubt be less sugar available for export in the years to come.

We hear much talk about India's large stockpile of sugar, typically about 10 million tonnes. Those days are gone. The second consecutive poor crop will not only completely eliminate India as a competitor on the export market, but India could emerge as an importer later this year. After years of harvesting 20-million-tonne plus crops, 2003-04 output reached only 16.7 million tonnes, and the 2004-05 is expected to yield 16 million tonnes. But domestic consumption continues to grow, and as a result, the USDA forecasts that ending stocks will fall to 4.4 million tonnes, compared with 8.3 million tonnes at the end of 2003-04 and 12.4 million tonnes for 2002-03.

At the moment, we are looking at a commodity that does not need China to facilitate a bull market. Over the past 3 years, Chinese production has increased by more than 20% over the crops it grew earlier in the decade and in the late 1990s, and it seems to have met rising demand. It is not even expected to meet the WTO import quota this year.

In summary, there are no looming shortages of sugar. We do believe, however, that the market is in transition and is adjusting prices that represented a period of abundance to a situation where the market is far more vulnerable to supply- or demand-side glitches.

[July 2, 2004]

STRATEGY: *Stay tuned.*

CORN

Can a bumper US crop alleviate historically low global inventories?

The last thing corn bulls needed was more bearish news, but bearish news was what they got. On June 30, the USDA released its second acreage estimate for the 2004-05 crop year. Planted acreage was revised upwards from the March 31 intentions estimate by a whopping 1.967 million acres, to 80.968 million acres. This compares with 2003-04 planted acres of 78.4 million acres. The figure was 786,000 acres more than the analysts' average guesstimate and fairly close to the high end of the range. Prices sank to fresh six-month lows on the news.

Although the street was expecting a downtick in soybean acreage, that estimate came in *below* analysts' guesstimates, which was an even bigger surprise. Based on historical price

comparisons, planting soybeans should have been more profitable for farmers who were able to hedge new-crop contracts, as illustrated in Chart 2. There were some fairly wild swings in this ratio during the planting season, however, which may have provided opportunities to plant corn more profitably in situations where the choice existed.

The quarterly stocks report that was released simultaneously showed that US corn stocks as of June 1 stood at 75.38 million tonnes, about 1 million tonnes higher than analysts' estimates. All in all, the outlook for US corn supply looked pretty good, and bulls looked pretty bad.

Plugging the additional supply into the global balance sheet obviously alters the landscape, but not by much. Using

the 87.8% average of planted-to-harvested-acreage ratio of the two previous seasons and assuming the USDA's very optimistic record-high yield of 145 bushels per harvested acre will hold, the June estimate for global production will rise by 2.62 million tonnes. This will further increase the record global crop to 646.45 million tonnes.

The increased acreage combined with higher US stocks and an assumption that there will be no changes to the demand side will increase global ending stocks to 72.48 million tonnes, or 10.9% of consumption. This compares with the USDA's June estimate of 10.4% and last season's 13.7%, so we're still in record low territory.

The crop is in good enough condition to assume decent yields. The forecast for record yields, though, is a tad premature. The good-to-excellent portion of the crop ticked up 1 percentage point this week to 71%, but is still down from 75% at this time last year. In addition, the acreage survey is made in late May and early June and could not have taken into account acreage that was lost to the excessive rains a few weeks ago.

Meeting the USDA forecast for US export sales is a key

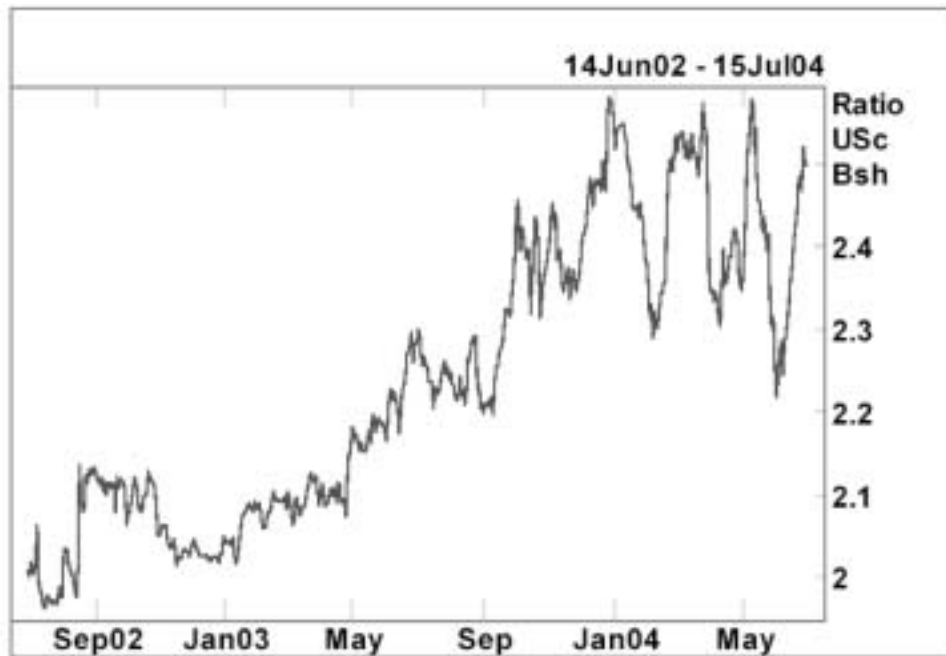
issue in determining how healthy demand is. Although we still remain far ahead of last year's pace, activity has slackened lately. Of particular concern was last week's old-crop commitments of 159,600 tonnes, which came in well below what we need for average weekly sales to meet the USDA's 52-million-tonne-target. Aside from one week at the end of May, when US exporters sold 1.2 million tonnes, sales have been sluggish. After that large sale, commitments have averaged only 360,000 tonnes per week. This week's commitment provided some relief as sales bounced back to 810,000 tonnes. With 9 weeks left to the marketing year, we will need to average just over 580,000 tonnes per week.

In conclusion, recent developments have obviously all been bearish. The US is headed for a record crop, and demand has taken a breather. Still, our principal bullish case over the past several months has been – and remains – the vulnerable level of global ending stocks. If the demand we saw earlier this marketing year were to resurface, even a record US crop will keep the market tight.

[July 2, 2004]

STRATEGY: *Stay tuned.*

Chart 2 – November soybeans/December corn



Courtesy Reuters

SOYBEANS

Explosive growth in production sends the bull home

The most extraordinary aspect of the soybean market at present is the market action in the old-crop/new-crop spread. After prices began to collapse in earnest in mid-May, the spread between July and November collapsed as well, to \$1.20 per bushel from a peak of over \$2.50 per bushel. Since mid-May, however, the spread has recovered completely, right back to its highs. In essence, though, there is nothing extraordinary at all about these events. They are merely a reflection of the fact that despite the release of all this bearish news, the US just about ran out of old-crop soybeans this marketing year. The collapsing spread was a bit of a misnomer, though, as evidenced by its rapid recovery. True, the market expects the new crops in North and South America to terminate this bull market, but until the new US crop is available in the fall, the market will remain tight.

The June USDA supply/demand situation report – the first complete look at the global picture for the 2004-05 crop year – presents a dramatically different market than we became accustomed to during the 2003-04 season. Farmers of the three countries that produce more than 80% of the world's soybeans – the US, Brazil, and Argentina – have all responded to the rapid increase in global demand for protein feed. All are expected to grow record crops that will be significantly larger than last year's.

In the June 30 planted acreage report, the USDA revised downwards its March intentions estimate by 600,000 acres, to 74.809 million acres. The market was expecting lower acreage, but the figure was 170,000 acres below the average of analysts' guesstimates. The crop will be a record nonetheless. Based on the 98.2 average of the planted-to-harvested ratio of the past two seasons and the USDA's forecast for near-record yields of 40 bushels per acre (yields reached 41.4 bpa in 1994-95, but have averaged 37.3 bpa since), the US will harvest a record crop of 80 million tonnes, 14.3 million tonnes, or 22%, larger than last season.

In Brazil, the 2003-04 crop was a disappointment. Based on planted acreage, the crop was expected to jump to over 60 million tonnes from the 52.5-million-tonne crop harvested in 2002-03. Inclement weather reduced the crop, though, back to

52.6 million tonnes. Now the USDA is forecasting a 25% increase for the 2004-05 crop, to 66 million tonnes. The Argentinean crop is expected to grow to 39 million tonnes, a 5-million-tonne increase over 2004-05.

All told, global output is forecast to grow to 224.28 million tonnes, 35.16 million tonnes, or 18.6%, above 2003-03 production. While consumption is expected to continue to rise as well, the USDA estimates that it will increase by only 15.4 million tonnes, or 7.9%, to 210.77 million tonnes. After adjusting for the June 30 report, which showed US quarterly stocks 430,000 tonnes higher than analysts' expectations, global ending stocks will grow to 46.43 million tonnes, or 22% of consumption. This compares with a stocks-to-consumption ratio of 16.8% at the end of 2003-04.

With 9 weeks left in the 2003-04 marketing year, meeting the USDA export sales target for the US should not present much of a challenge. Exporters have already shipped 23.4 million tonnes, 95.43% of the 24.49 million tonnes forecast for the year, upon which US ending stocks estimates are based. Domestic consumption remains solid. With crush margins soaring, we can be certain that demand from crushers will remain strong, and spot prices will stay firm until the first beans of the 2004-05 crop are harvested. Hence, the dramatic rally in the July/November spread.

Will this demand continue into the new marketing year? The Chinese cancellations of Brazilian shipments threw a wet blanket over this market. It is difficult to know for sure if the ships that were turned back from Chinese ports were the result of oversupply or if the Chinese had no qualms about renegeing on commitments knowing they'll be able to buy new crop beans at steep discounts, as illustrated above.

With the summer weather season, and the volatility that it brings, upon us, we'd just as soon stay sidelined for the moment. Hot and dry weather will cause rallies periodically, but unless there is a crop failure or the USDA is off with its demand estimates by a wide margin, this market has seen its peak.

[July 2, 2004]

STRATEGY: *Stay tuned.*

HOTLINE UPDATE

Flash Update – Wednesday, June 9, 2004:

Good afternoon for Wednesday, June 9, 2:30 pm. This is a Flash Update. We have liquidated our long July wheat position at 360.

Thursday, June 10, 2004:

Good afternoon for Thursday, June 10, 4:55 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On June 9 we liquidated our long July wheat position at 360.

We are currently long December gold at 386, with our stop at 370. All stops are close only.

Flash Update – Monday, June 14, 2004:

Good morning for Monday, June 14, 9:50 am. This is a Flash Update. We have sold short September mini S&P at 1130, placing our initial stop at 1150, close only.

Friday, June 18, 2004:

Good afternoon for Friday, June 18, 4:45 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On June 14 we sold short September mini S&P at 1130.

We are currently long December gold at 386, with our stop at 370, and short September mini S&P at 1130, with our initial stop at 1150. All stops are close only.

Friday, June 25, 2004:

Good afternoon for Friday, June 25, 4:40 pm. The following is a recap of our latest recommendations and stop levels: We are currently long December gold at 386, with our stop at 370, and short September mini S&P at 1130, with our stop at 1150. All stops are close only.

Flash Update – Monday, June 28, 2004:

Good afternoon for Monday, June 28, 3:20 pm. This is a Flash Update. We have liquidated our long December gold position at 404.

Friday, July 2, 2004:

Good afternoon for Friday, July 2, 4:05 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On June 28 we liquidated our long December gold position at 404. We are currently short September mini S&P at 1130, with our stop at 1150. All stops are close only.

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