

# FRIEDBERG'S

## FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 9, No. 6 July 6, 2006

## Cocoa: Will strong West African mid crops cap the rally?

The cocoa market absorbed rather well two bearish supply-side developments that surfaced recently – for the moment anyway.

First, while the Ivorian main-crop put in a dismal performance, the mid-crop has exceeded expectations. According to our calculations, the mid-crop now stands at about 335,000 tonnes. The mid-crop typically reaches about 200,000 to 250,000 tonnes. When analysts spoke earlier in the season about reaching 300,000 tonnes, we thought they were being overly optimistic. If the mid-crop season lasts as long as it did last season, it should hit 370,000 tonnes.

Data published earlier this week indicate that as of June 18 combined main- and mid-crop port arrivals in the Ivory Coast hit 1.25 million tonnes. This is already more than 55,000 tonnes above E.D. & F. Man's February estimate for the total crop of 1.195 million tonnes.

Then, West African neighbor Ghana announced that it would harvest 700,000 tonnes. Production was expected to top 2004-05 output of 585,000 tonnes, but not nearly by this much.

If everything else remains the same, the effect on the bottom line is substantial and would shrink Man's proposed 220,000-tonne global deficit to a much smaller deficit of perhaps 50,000 tonnes.

One mitigating factor is that the surprising showing for these two countries comes from mid-crop beans, which can be significantly smaller than those of the main crop and which produce less butter and powder per tonne of beans. The main crop typically produces 90-100 beans per 100 grams, whereas mid-crop beans can be 120 per 100 grams and less.

A longer-term bearish supply-side development is the ample rainfall currently falling over the cocoa regions in the Ivory Coast. The precipitation is beneficial for the new crop to be harvested in October, but does not affect the

supply/demand balance for the current marketing year.

The primary reason offered by news-wire analysts for the market's relative strength – September cocoa is trading up at the high of the recent range – is short-covering by commodity funds. This argument, however, is technically inaccurate because the June 23 Commitment of Traders data show that both funds and small speculators are net long the market and have been since early May. If anything, speculators were reducing their net long position over the past few weeks on this rally, which actually sets up a bullish indicator, because that would mean that commercial traders are buyers at these levels.

The increased supply definitely serves to downgrade our bullishness by a notch, but as illustrated, we are encouraged by the market's strength. Second-quarter grinding statistics for Europe and the US will be released in July, and we expect them to show positive results.

True, we don't have much to support this view with, other than the positive market action. The only hard data that

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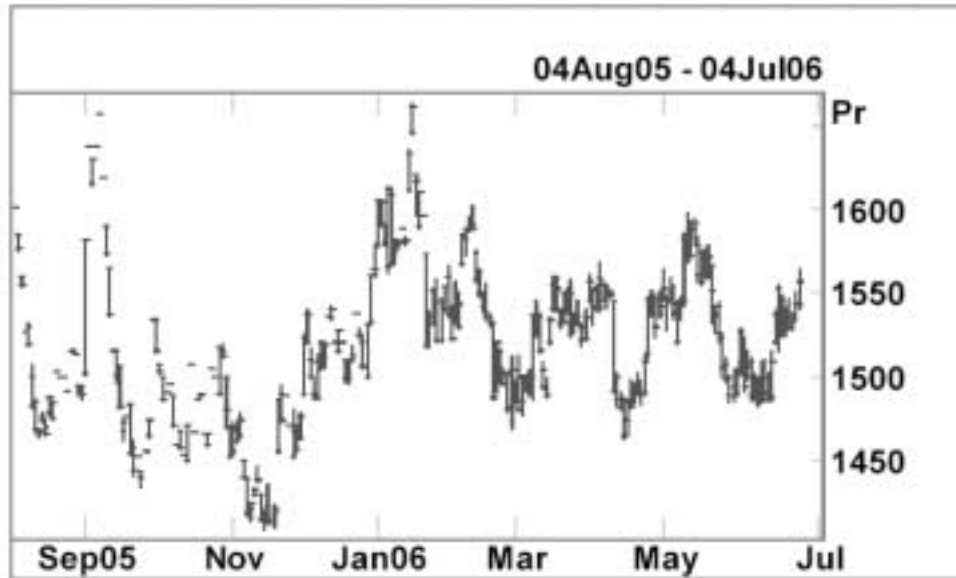
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indicate that demand remains steady is the fact that butter ratios in Europe are trading at about 2.6 times the London spot price. The ratio has slipped from about the 2.7 level we've seen over the past several months. But at 2.6, the ratio is still at a fairly high level in historic terms and leads us to believe that grinding is quite profitable.

In our recent articles on cocoa, we calculated that global ending stocks would fall below 40% of consumption. The

revised outlook for West African crops puts us back to the 45%-of-consumption neighbourhood, which changes the outlook considerably. The demand data could therefore be crucial in determining the direction this market takes in coming months. We remain friendly to the long side, and the only change in strategy we would make at this time is to recommend placing stops at 1480, close only, basis the nearest contract month. [June 27, 2006]

Chart 1 – September cocoa



Courtesy Reuters

## SUGAR

### Major producers respond to ethanol crisis with record crops

The bull market in sugar ground to a halt in early February just a tad shy of the 20¢-per-pound level. In the April 27 issue of *Focus on Futures* we explained that the market responded rather quickly to the jump in demand for sugar-based ethanol. Brazilian and Indian crops ballooned, and rising ethanol prices put a crimp in the growth rate of ethanol usage. The market adjusted to these developments, falling 25%. Prices have now stabilized. Was the slide in prices just a correction in a long-term bull market or is the international-trade sector of the sugar market now comfortably supplied?

Well, the long term is difficult to predict, but as far as the nearer term is concerned, the factors that ended the bull run have not changed very much. While sugar prices were going

up, the demand for ethanol – particularly in Brazil – seemed insatiable. Analysts, including us, were predicting that the food/fuel cane-crush ratio would move quickly in favor of ethanol. It had already crept over the 50% mark, and there was talk of the ratio reaching 54%/46% in favor of ethanol over the coming years. It is now quite clear that this is not the direction the market is taking.

Rising domestic ethanol prices in Brazil put a cap on runaway consumption. On March 1 the government-mandated ethanol/petroleum ratio, which fuel suppliers are required to maintain, was lowered to 20% from 25% to bring usage under control.

While the demand side slowed this market down, the supply side has been no help. On May 31 the Brazilian

government released its first estimate of the new crop, which went into harvest in May. It estimates that output will grow by 8.2% over 2005-06, to 423.4 million tonnes of cane. This is substantially higher than the International Sugar Organization's May 17 estimate of 415 million tonnes. What's even more bearish, though, is that the government says that 56% of the crop will be crushed into sugar (29 million tonnes of raw sugar), leaving only 44% for ethanol (17.8 billion litres), which will leave plenty of sugar for domestic consumption and – more significantly – Brazil's export pipelines well supplied.

With global ethanol demand on the rise, it follows that this crush ratio will in turn tighten the ethanol market, particularly if export demand continues to grow. Indeed, analysts do not expect 2006 Brazilian ethanol exports to exceed 2005 sales of 2.5 billion litres, because industry and government have a strong incentive not to choke the domestic market, which consumes 13 billion litres per annum. As a result, the portion of the cane crop that ends up as ethanol may not be sufficient for the ethanol market, thus keeping prices firm, but it will ensure ample supplies of sugar.

The only issue remaining on this front is that the above estimates were based on data collected before the recent spell of poor weather, which is threatening to

reduce yields. Rainfall in the principal growing regions in Brazil was 72% below normal.

Meanwhile, on June 22, F.O. Licht raised its estimate for the 2005-06 Indian crop to 20.4 million tonnes from its previous estimate of 19.5 million tonnes. Monsoon precipitation is still crucial, though. Based on planted acreage, the 2006-07 crop, which is harvested starting in October, is expected to reach 22 million tonnes.

Having presented a mostly bearish case, we should point out that global ending stocks stand at about 40% of consumption, their lowest point in many years. This may not seem very low in terms of many of the markets that we trade, but it is low for the sugar market. After all, whatever pockets of tightness emerged was on account of insufficient inventories and that was enough to cause prices to triple.

The growth of the ethanol market is likely to be permanent and while it may have leveled off for the moment, there are limitations on how long the Brazilian government and industry can intervene to keep the crush ratio where it is before market forces take over and make it more attractive to crush cane for ethanol.

For the moment, considering the huge harvests that will be available in the coming months, we expect the market to drift lower, and we recommend standing aside.

[June 30, 2006]

Chart 2 – October sugar



Courtesy Reuters

**COPPER****Taking a breather?**

The bull market in copper has been truly extraordinary. Prices have skyrocketed from 60¢ per pound in November 2001 to a peak of \$4.16 per pound this past May. We've been in a broad-based commodity bull market during this period, but none of the other major internationally traded commodities can lay claim to a sevenfold increase in price. Was the \$1-per-pound pullback in copper prices we saw over the past two months part of a sweeping correction in commodity prices or is the air leaking out of the bubble?

That it is a bubble, we have no doubt. It's not been an easy point to prove, though. On the surface, analysis of the open interest – both COMEX and LME – provided few clues as to what was really going on. Open interest never ballooned to previously unthinkable levels the way it did for other commodities (e.g., corn and sugar). If anything, consistent monitoring of the Commitment of Trader data showed very clearly that it was not commodity funds who were doing all the buying. Rather, commercial traders were, which we normally consider a buy signal. Commodity funds were net-long copper for most of the ride, but as a group, they've been liquidating their net-long position since early 2005.

The problem is that the behavior of copper prices may have been logical in this open interest context, but remained confusing because a bullish case could not be made that was anywhere near in sync with the supply/demand fundamentals. The market ended 2004 with a massive global supply/demand deficit of close to 900,000 tonnes. After that, however, despite the fact that mine-production growth did not live up to its potential, the market moved steadily toward surplus. By the end of 2005, the global supply/demand balance showed a tiny surplus.

More recent data show that this trend is continuing. First, the big story in the copper market that was understood to be the powerful driver behind the bull market was Chinese usage. With the Chinese economy growing at double-digit rates, it made perfect sense that the rapidly modernizing and most-populous country in the world would need all that copper to build new infrastructure. That may have been true a

while ago, but the numbers don't wash any longer. According to customs data, Chinese copper imports fell 60% from the beginning of the year through the end of May, compared with the same period last year.

Then, on the supply side, Chilean mine production has still not shown its potential, but the numbers are showing some improvement. The most recent data, released on June 28, show May output up a scant 0.7%, but April was up 8.7%. We haven't seen that kind of jump in output for quite some time, and it may be the start of further large increases.

There have been many temporary production glitches in the principal mining regions, but it is inconceivable, with all the capacity coming on stream and fantastically profitable margins, that we will not see output rise. The International Copper Study Group (ICSG) estimates that global mine capacity will grow by 4.3% per annum between 2005 and 2009. In a recent report, the ICSG said that annual mine capacity will reach 19.6 million tonnes by 2009, compared with 16.6 million tonnes at the end of 2005.

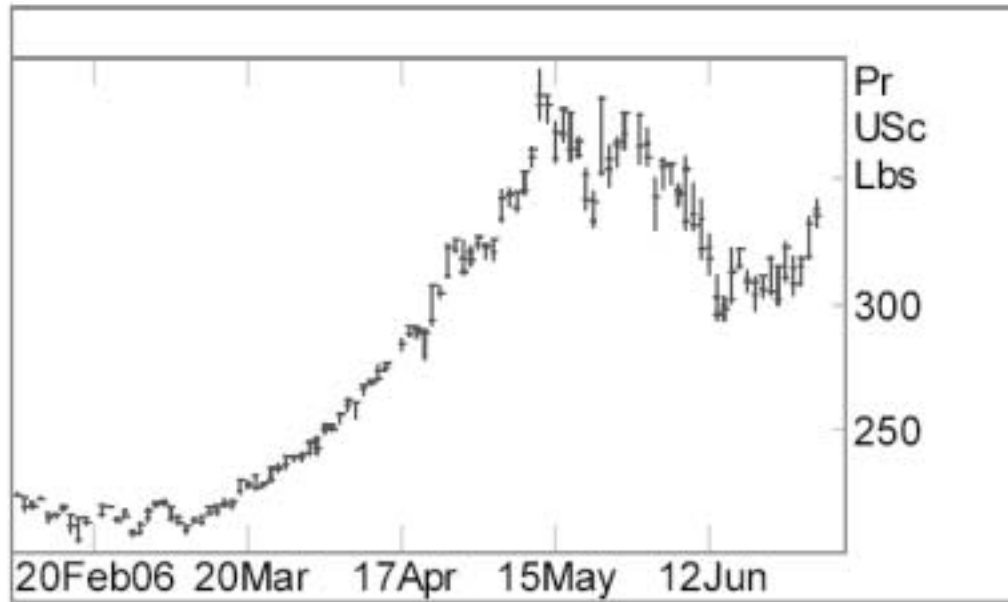
Summing it all up, the ICSG June 27 report showed the global supply/demand balance at a 64,000-tonne surplus for the first quarter of this year. This compares with a deficit of 89,000 tonnes for the first quarter of 2005.

We are not bullish. Especially at these price levels. Even after the sharp drop, prices do not reflect economic realities of the mining industry. We are light years above the cost of production, and mining companies can produce and over-produce and still turn lavish profits.

We maintain a strong bearish bias, but the market can continue upwards, much the same way it has been, without any real bullish supply/demand fundamentals. We recommend careful monitoring of the cash-to-three-month spreads, both at COMEX and the LME. In addition, the drop in Chinese imports may be a leading indicator of a slow-down in the Chinese economy. If the economic data begin to reflect a downturn, we would feel more confidence in shorting this market.

*[July 3, 2006]*

Chart 3 – September copper



*Courtesy Reuters*

## **CORN**

### **Correction just a pit stop in long-term bull market**

During the last half of May and all of June, corn prices plunged 45¢ per bushel, erasing just about the entire rally that began in January. The early-year strength was the result of two factors: 1) the rapid growth of the ethanol market and the tangible effect it was having on corn supplies; 2) the US – the world's largest producer and exporter of corn – was slated to see a sharp drop in acreage for the 2006-07.

Growth in ethanol usage is gaining momentum. Large corporations are investing significant capital to create processing infrastructure, which means they are certainly treating the future of ethanol very seriously. The fundamental explanation to the slide in prices was pinned on acreage.

The March 31 USDA planting intentions report estimated a rather spectacular 4.6% (3.78 million acres) drop in corn acreage to 78.02 million acres from the 2005-06 season. But it soon became obvious that the forecasted cut in acreage was too steep. Arguably, the high prices we saw in early spring ultimately contributed to the weakness. Where farmers were still able to choose between corn and beans, corn became the better choice, because they were able to hedge at reasonable prices, whereas soybeans were stuck in a range and offered little opportunity to lock in a profitable crop.

Indeed, the June 30 planting intentions report revised the acreage estimate upwards 1.35 million acres, to 79.366 million acres.

(Of note, the estimate for soybean acreage was down a hefty 1.97 million acres, to 74.93 million acres.)

The result was below the average of analysts' estimates of 79.802 million acres, and the market greeted the news with a rally. While it is significant that the street was off on its estimate, analysts suspected that the USDA went too far in March and that we would see a significant upwards revision. An inverse of the old adage buy the rumor, sell the news.

We view the large drop in prices over that past one and a half months and the subsequent reaction a bit differently. We don't think the fundamentals have changed at all. Open interest has doubled from its normal levels, to over 1.3 million contracts, in a period of one year. Many commodity markets saw a substantial increase in activity, but commodity funds were particularly excited about the corn market because of the ethanol story and built an absolutely gargantuan net-long position that reached over 260,000 contracts. The broad correction in commodity prices that saw gold fall almost \$200 per ounce took many markets down, and corn was no exception.

The interesting feature of the correction in the corn market is that even while the net-long position of commodity funds has dropped to 154,000 contracts, open interest still sits at 1.32 million contracts, barely a smidgeon off its peak. Other markets that experienced large corrections, however, saw open interest pullbacks commensurate with the drop in prices. What this means, of course, is that the long position is switching hands from speculators to commercial interests, which only serves to reinforce our confidence about the long-term direction of this market.

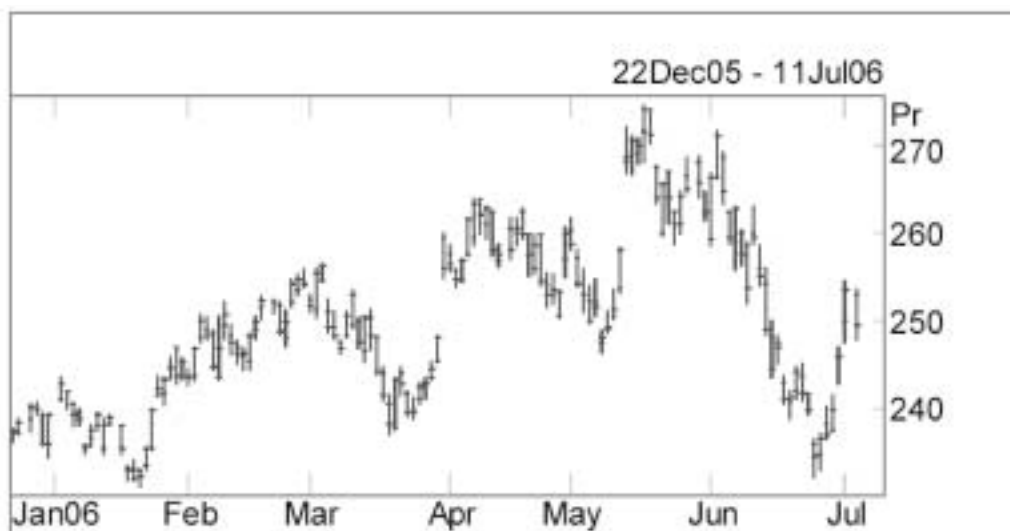
In any case, the net effect of the change in the acreage estimate is an increase in the global corn supplies of 5.1 million tonnes (using the USDA's June estimate for yield of 149 bushels per acre). This would increase projected 2006-07 global ending stocks to 95.28 million tonnes, or 13.2% of consumption, up from the June estimate of 12.89%, but still much below 2005-06 ending stocks of 18.8% of consumption.

Besides, US exports have been so strong that the USDA could very likely raise its projection for global demand in its July estimate, which could negate a good chunk of any headway made by increased US supplies in closing the widening global production/consumption deficit. This past week, combined old- and new-crop commitments were an unbelievable 2.026 million tonnes. Exporters are 1.3 million tonnes away from meeting the 52.7-million-tonne sales target. And with 10 reporting weeks left in the marketing year, they're sure to exceed it. Shipments need only maintain their weekly average to meet the forecast.

Our recommendation has not changed. Remain long and look for much higher prices. [July 6, 2006]

Our recommendation has not changed. Remain long and look for much higher prices. [July 6, 2006]

Chart 4 – September corn



Courtesy Reuters

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