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India's production problems continue to dominate the sugar market

The recent 4.5% rally in the US dollar triggered a steep selloff for many commodity markets. To be sure, some commodities had strengthened for no apparent reason related to their supply/demand fundamentals – and it would be those that fell the hardest when the dollar rose. As soon as the dollar resumed its downtrend, sugar prices sprinted to new highs (Chart 1). No other commodity on the board can lay claim to that feat.

Whenever we've seen commodity market weakness over the past six months or so, it has typically been the result of an anticipated drop in consumption. In many cases the fears were well founded. The dramatic collapse of Indian sugar production, however, superseded whatever loss of demand was suffered by the sugar market. Czarnikow's most recent estimate puts the 2008-09 global deficit at 15.6 million tonnes.

The spike back to the highs was probably a delayed reaction to news out of India that the government was extending the July 9 expiry of the restriction it had placed on sugar stocking by traders. The measure was taken to ensure adequate domestic market supplies.

In addition, there is speculation that the July 31 deadline for importing sugar tax-free and without other attached constraints will be extended as well. Obviously, whatever sugar was imported over the past few months has not been sufficient to both meet demand and begin the restocking process. Import estimates currently stand at 2.5 million tonnes of raw sugar for the 2008-09 marketing year, which ends in September, and 3 to 4 million tonnes in 2009-10. Based on recent legislative activity, it would seem very likely that these estimates are stale, at least for 2008-09.

Bears have been arguing that this rally cannot get too far, because the Indian cane crop will bounce back to normal levels. Indeed, some estimates indicate that acreage can be up as much as 25% in key growing regions. But it's not that simple.

One problem is that prices paid to farmers provide a greater incentive for wheat and rice planting, so there could be a gap between planting intentions and actual acreage.

In addition, the monsoon season must cooperate. Since it began in early June, however, the rains have been below normal levels.

Consider that domestic consumption in India is estimated

at a record 23.5 million tonnes. Assuming normal growing conditions, the estimate for 2009-10 production is 20 million tonnes. With the farmer compensation issue, the poor start to the monsoon season, and inventories down to just a few million tonnes, it is a near certainty that imports will have to increase.

Australia – an important supplier to Asian importers – is expected to see its output decline by 3% over 2008-09.

China has never been much of a force in the sugar market, because it has been largely self sufficient. That is slowly changing. Output for the coming crop year is estimated at 12 million tonnes against consumption of 14 million tonnes. The deficit is made up from carryover stocks of about 2 million tonnes, but how long will that last?

For the moment, Brazil is supplying the world. The combination of a 7% increase in output for the crop currently being crushed and a lower ethanol/sugar crush ratio is facilitating the availability. Only 57% of the crop is being turned into ethanol, compared with 60.4% in 2008-09.

The global deficit for 2009-10 is estimated to shrink, but will still be about 6 million tonnes, which will draw global stocks down further. Prices are obviously not high enough to motivate an increase in production. The 20¢-per-pound high we touched in 2006 is within striking distance (Chart 2). Remain long.

[June 25, 2009]

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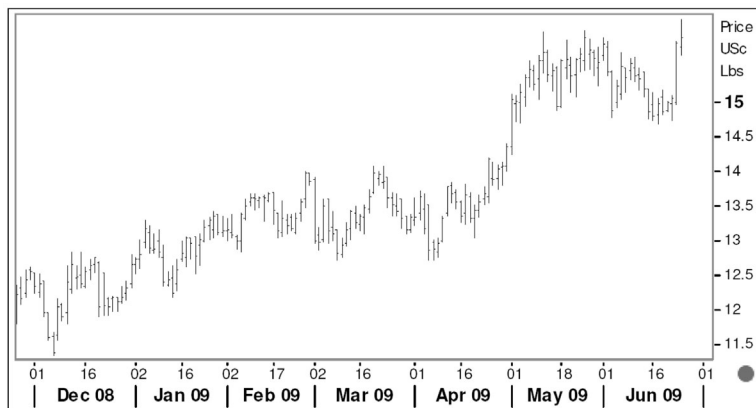
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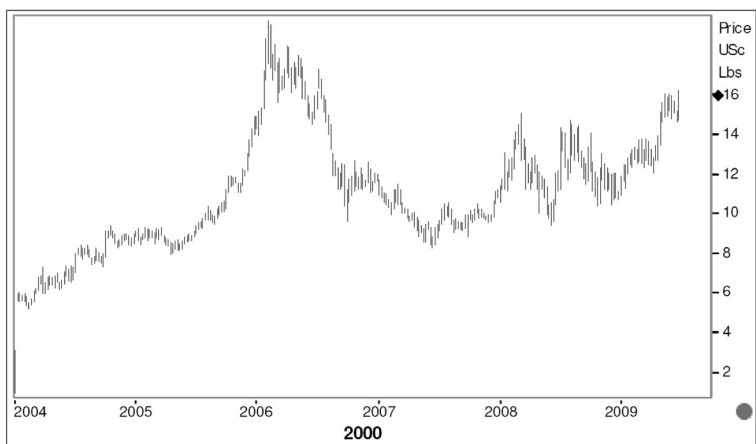
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Chart 1 – July sugar



Courtesy Reuters

Chart 2 – Weekly sugar



Courtesy Reuters

COTTON

Prices survive a bearish acreage report

Cotton prices put in a bottom late last year. The market then rallied by 25¢-per-pound, and most recently has given back about half of that rally (Chart 3).

After a monumental 28% leap to 120 million bales in 2004-05, average global output stayed at about the same level through 2007-08. Demand grew as well, but supplies were ample. Prices traded in a narrow range between 50¢ and 60¢ per pound for three full years. When consumption exceeded production by a wide margin in 2007-08, we got the monster rally to 90¢ per pound. Then came the recession and a steep drop in demand with a commensurate collapse in price.

The market correctly anticipated a sharp drop in consumption, but there have been no surprises on that front for some time now. For that matter, by the time the USDA estimates – which were too high – began catching up to actual

plummeting US domestic usage as represented by mill consumption, the market had bottomed. Commercial consumption remains well below last year’s levels, but monthly data show that we’ve maintained a steady annualized rate for many months now, which could mean that the drop in demand is over.

US exports, on the other hand, while still below last season’s level, continue to surprise on the upside. Commitments now stand at 13.5 million bales, above the USDA estimate for final sales of 12.7 million bales. Shipments to date are 11.1 million bales. We won’t ship all the commitments, but shipments have averaged well over 250,000 bales per week over the past month, and with six weekly reporting periods left to the marketing year, we should have no problem meeting and perhaps even surpassing the USDA target.

As we head into the new 2009-10 marketing year, we are

looking at a second consecutive season of declining global production, but a reversal in the trend for lower demand. In the May supply/demand situation report, the USDA forecast a small drop in output, but a 2.6% increase in demand.

On June 30, the USDA released the much awaited acreage report. Heading into the report, most market observers, which would include us, believed that there was little chance of a bearish report. Chart 4 shows how soybean prices have skyrocketed *vis-à-vis* their traditional relationship with cotton. While it is true that new crop soybeans were already heavily discounted to the spot price (Chart 5), soybean planting was still far more profitable than the historical norm (Chart 6). But the street was wrong. The actual acreage figure came in at 9.054 million acres, against an average guesstimate of 8.779 million acres, and above the highest estimate of 9 million acres.

Using the May estimates for yield and planted-to-harvested acre ratio, the US crop would be 13.6 million bales, 350,000 bales above the May estimate, but the smallest crop since the 1989-90 season. This would still leave global out-

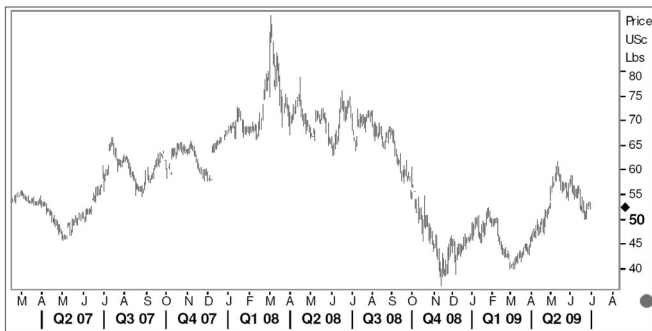
put below last year, but only marginally.

In 2007-08 India exported 7 million bales, making it the world's second largest single-country exporter, behind the US with 13.65 million bales. In 2008-09 a poor crop allowed exports of only 2 million bales, but this year the crop is expected to bounce back, and exports are forecast at 6.4 million bales. But the Indian crop depends heavily on a successful monsoon season, and thus far the weather has not been ideal, but there is ample time. Should the monsoon not improve, the estimate for the current forecast for a record crop of 25 million bales could not be achieved.

To be sure, the acreage report was a disappointment for bulls. Although the USDA's estimate for 2009-10 global consumption at 113 million bales is still a recessionary number, production has fallen enough to nevertheless continue to draw down inventories.

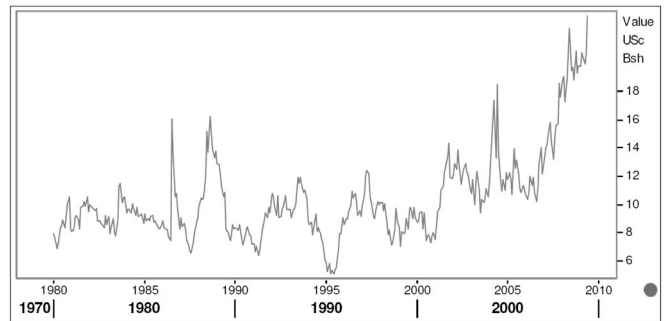
On the day of the release of the acreage report, after an initial selloff, the market closed out the session with a modest gain, not a bad reaction for a bearish report and a vote of confidence for bulls. Remain long. [July 1, 2009]

Chart 3 – Nearest contract cotton



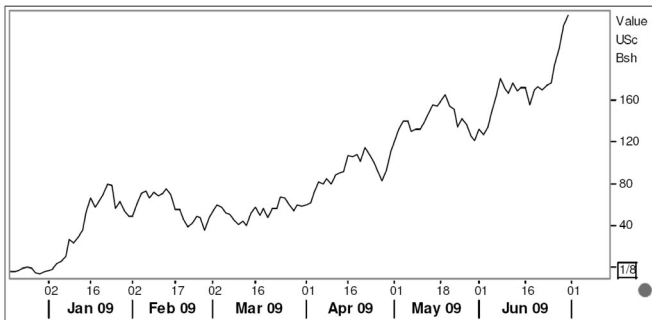
Courtesy Reuters

Chart 4 – Soybean/cotton ratio



Courtesy Reuters

Chart 5 – Old crop July/new crop November soybean spread



Courtesy Reuters

Chart 6 – New crop November soybeans/New crop December cotton ratio



Courtesy Reuters

CORN

US corn farmers go wild

The results of the June 30 acreage report for corn were not surprising. They were downright shocking.

The March 31 planting intentions report estimated that 84.98 million acres would be planted to corn. A very wet spring hampered planting activity to the extent that it was widely believed that many corn acres would not be suitable for seeding by the time the planting window closed. By May 17, only 62% of the crop was planted, compared with 70% on that date the previous season, and substantially below the 5-year average of 85%. But the June 30 update stunned traders. US farmers planted 87.035 million acres of corn. That is more than 3 million acres above the average street guesstimate and over 1 million acres above the highest estimate. Soybeans, which can be planted later, would be the obvious beneficiary. Not so, as it turned out. Soybean acres were actually 640,000 acres below expectations.

So how could all the private forecasters have been so wrong? Well, there is no good answer to that question. The improvement in weather in late May and early June was obviously significant and allowed farmers to compensate for the late start.

Aside from the weather issue, it was also assumed that the historical profitability ratio would favor soybean planting where the choice existed. Chart 7 shows that the soybean/corn ratio is the highest it's been in over 30 years. Although traders' expectations of a large soybean crop pushed new crop soybean prices to a large discount behind spot beans (Chart 8), the historical price advantage of planting beans over corn was still prominent (Chart 9).

Adding a bit of insult to the bulls' injury was the quarterly stocks report – released together with the acreage report – which confirmed that domestic consumption is lackluster. June 1 stocks stood at 4.226 billion bushels, 88 million bushels above expectations, and 238 million bushels above last year at this time. The market greeted the dual reports with

a solid limit down performance (Chart 10).

So is this the end of the bull market, and do we now head back to corn with a \$2-per-bushel handle?

The USDA's early forecast for the 2009-10 season was looking for global production to be down slightly from last season, but for a recovery in consumption. According to the June supply/demand situation report, these estimates would have drawn inventories down to 125 million tonnes, or 15.7% of consumption, down from 17.8% in 2008-09. The implied increase in output that will result from the revision in US acres will bring the stocks-to-usage ratio up to 16.7%. While this is certainly an improvement, it does not represent a material change to the overall tight global balance sheet.

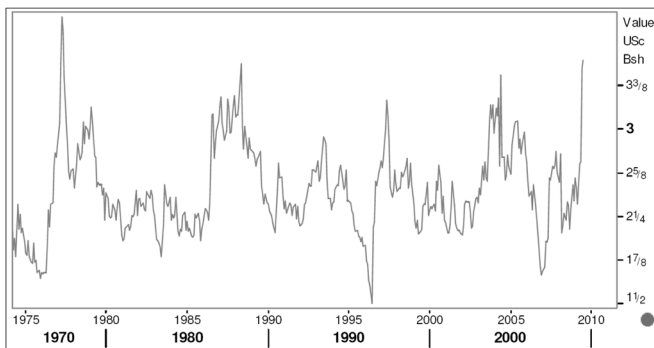
The USDA is forecasting a tepid recovery in US exports for 2009-10 to 48 million tonnes, up from 44 million tonnes this year, but still down from 2007-08 sales of 61 million tonnes. That may be a conservative estimate. With two months left in this marketing year, export commitments stand at 43 million tonnes and shipments at 34 million tonnes. Old-crop sales will start to taper off, but in all likelihood, commitments will exceed the USDA target – unimaginable a couple of months ago. Whether it all gets shipped before the season ends on September 1 is another story. But foreign buyers are showing strong interest.

The US crop may have been planted late, but the most recent reading on the condition of the crop is actually fairly impressive. The good-to-excellent portion of the crop is 72%, compared with only 61% at this time last year.

In conclusion, recent developments have to be considered bearish. Nevertheless, the market has already fallen by \$1 per bushel just since mid-June. As illustrated, the global inventory situation got a boost, but has not been solved.

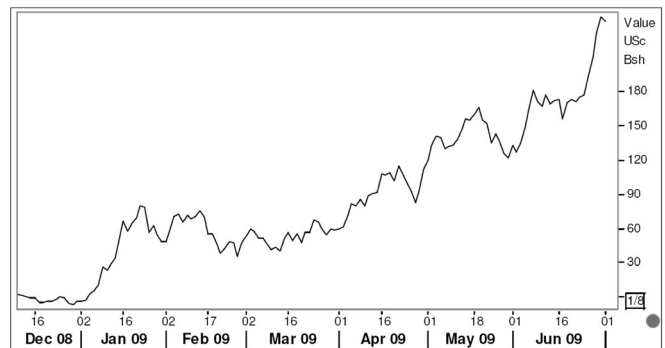
Try to hang on to long positions. A close below the December lows, and that's not too far away, should be used as a stop. [July 2, 2009]

Chart 7 – Soybean/corn ratio



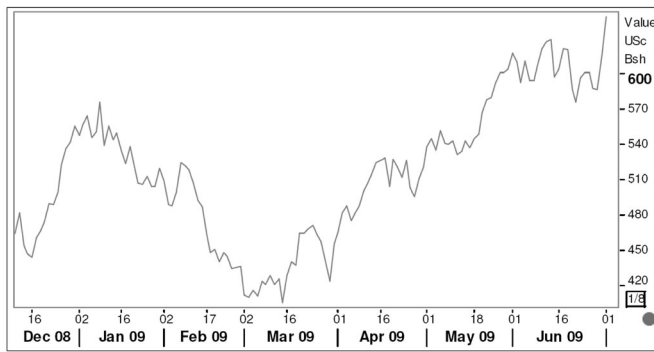
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Chart 8 – Old crop July/New crop November soybean spread



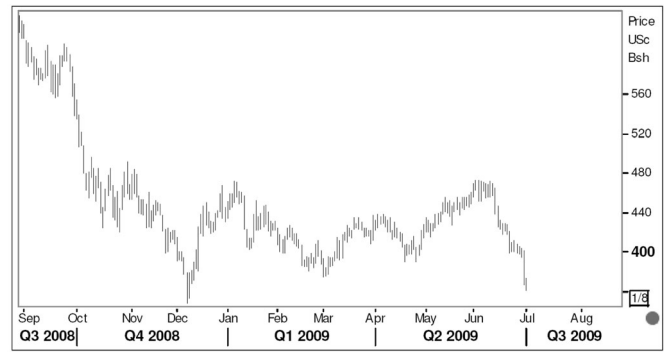
Courtesy Reuters

Chart 9 – New crop November soybeans/New crop December corn ratio



Courtesy Reuters

Chart 10 – December corn



Courtesy Reuters

SOYBEANS

No monster crop

In the period following the March 31 USDA planting intentions report and leading up to the release of the June 30 acreage report, the action in the soybean market gave all the appearances of a tight near-term market, but one that would be amply supplied once the new crop is harvested in the fall. Old-crop July beans gained over \$1.50 per bushel over new-crop November (Chart 11).

For the US, the outgoing marketing year will finish with ending stocks of 110 million bushels (2.99 million tonnes), or 3.6% of usage. That is the lowest carryout in history. Common sense dictated that with prices at historically high levels, even with new-crop months heavily discounted, farmers would plant all they could. In addition, it was taken for granted that a wet spring would restrict corn planting and that the acres that could not make it in time for corn would go to beans.

The acreage report showed that, indeed, the US planted a record high 77.48 million acres to soybeans, 1.77 million acres more than last season. The problem was that the figure came in 600,000 acres below the average analysts' estimate. It was the type of situation where observers privately believed that the estimate would come in at the high end of expectations, and perhaps beyond, given the list of motivating factors that farmers had for planting soybeans. The market was taken by surprise, and prices, which had been falling prior to the report, rallied right back into the range (Chart 12).

Using the June USDA yield estimate of 42.6 bushels per acre, the difference between output implied by the revised acreage data and trade expectations was about 26 million bushels. The accompanying quarterly stocks report provided a bit of a bearish countereffect, with June 1 inventories at 597 million bushels, 12 million bushels above expectations.

In the grand scheme of things, the actual data did not make much of a dent in the way the balance sheet was expect-

ed to emerge from these reports, one way or the other. True, there is puzzlement over why the increase in acreage was not much larger, but the estimate still represents a 1.5-million-acre jump over March 31 intentions. This would put the estimate for US 2009-10 ending stocks at about 273 million bushels (7.43 million tonnes), which translates into a fairly big jump to 8.8% of usage, which compares with 6.7% in the June USDA supply/demand situation report.

A large and healthy US crop is absolutely vital to avoid shortages, though. There is no room for glitches. Poor weather for the growing season this summer would spell absolute disaster.

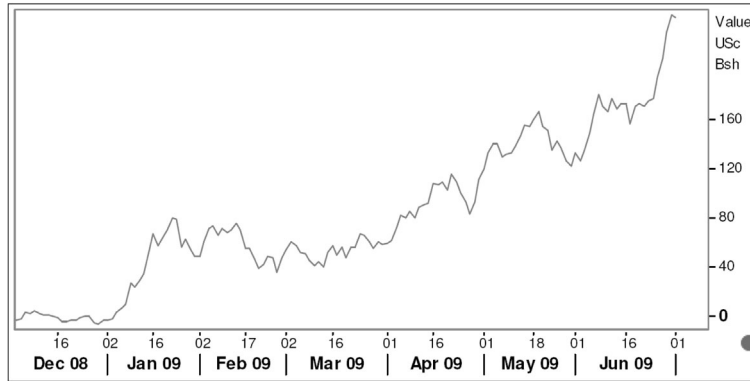
South American crops are expected to return to normal, but that does not help until next March. In the meantime, we are working with a drought-stricken 32-million-tonne Argentinean crop, down from 46 million tonnes a year earlier.

US exports have been the story in the soybean market. It's been the only agricultural market sector that has seen better performance in recession-plagued 2008-09 than it did in the previous season. It was all about Chinese restocking, but the large volumes have dried up. When taking into account cancellations, total old crop commitments over the past four weeks have averaged a mere 22,000 tonnes. New crop sales averaged 165,000 tonnes. Unless cancellations pick up, meeting the USDA target for 2008-09 sales of 34 million tonnes should not be an issue. Commitments stand at 33.8 million tonnes, 30.3 million tonnes have been shipped, and there are two months left to ship the balance.

We've been bears because we thought the US would produce a mega-crop. It's been a confusing market, with old crop and new crop contracts acting like two completely different commodity markets. We're going to choose to stand aside for now.

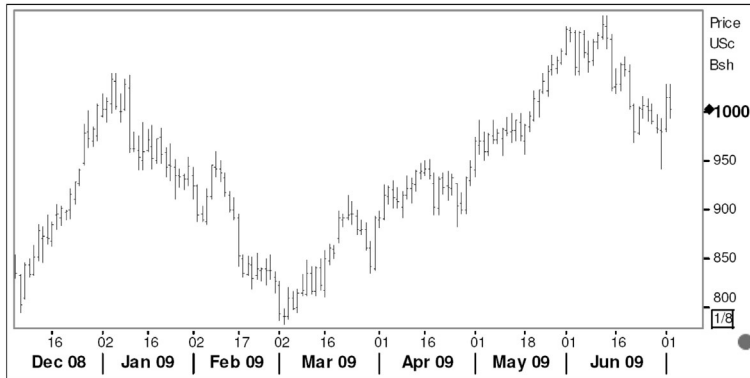
[July 2, 2009]

Chart 11 – Old crop July/New crop November soybean spread



Courtesy Reuters

Chart 12 – November soybeans



Courtesy Reuters

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