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Wheat: supply-side challenges

Wheat prices began to firm in late January when the Ukrainian/Russian crisis started to look serious. Unlike many such rallies that are spurred by geopolitical crisis, this one did not fade away after a few days – or weeks, for that matter. Normally, the headlines create panic, and traders react spontaneously, but after assessing the facts, prices retreat. Here we are in May, however, and wheat prices are trading at six-month highs.

The potential fallout from the Ukraine's new isolation from Russia is proving to be something more than just a knee-jerk reaction. There are two potential issues that could affect the global wheat market.

About 95% of the Ukrainian wheat crop is winter wheat – planted in the fall and harvested in July and August. The 2013-14 crop was harvested last summer. There are still 2.5 million tonnes of old-crop wheat commitments remaining to be shipped. Most Ukrainian grain exports are shipped abroad from Black Sea ports on Crimean shores – now effectively controlled by Russia. Exports from the 2014-15 crop, which will be harvested this summer, also remain vulnerable to the viability of Black Sea ports if there is no resolution to the crisis.

Russia and the Ukraine are the world's fifth- and sixth-largest exporters of wheat, respectively. For the current 2013-14 marketing year, Ukrainian wheat exports are estimated at 9.5 million tonnes, or 6% of world trade. Clearly, if Ukrainian access to its shipping infrastructure is in jeopardy, global wheat supplies could be affected. For the moment, it seems that it is business as usual at Black Sea ports. Still, the market is building a premium in the event that the situation escalates.

Looking further down the road, the second issue, and perhaps a more real concern, is the strong possibility of a strained financial relationship between the Ukraine and Russia, which could restrict credit for Ukrainian farmers and hamper their ability to purchase seed and fertilizer. The size of the 2015-16 crop – which will be planted this coming autumn – can shrink dramatically.

A workable resolution to the standoff would alleviate fears. However, credible analysts are voicing concern that Russia has dug in its heels and that the crisis is far from over.

The other factor driving wheat prices is the outlook for

the US winter wheat crop. A brutally harsh winter has left the crop with drought in some regions and early spring frost in others. Analysts are slashing their estimates for the crop that will be harvested this spring. The most recent weekly crop-progress report puts the good-to-excellent portion of the crop at 31%. That compares with the five-year average of 48% at this juncture of the season.

Of note, at this time last year 2013-14 crop conditions looked equally dismal, and by the conclusion of the harvest, the abandonment rate was the highest since the 2002-03 crop year. The US muddled through with a decent-sized crop only because planted acreage was the highest since 2009-10. Unless there is a dramatic improvement, a smaller-than-expected US crop is a near certainty.

Another matter that traders will have to grapple with is the effect that a strong El Niño will have on Southern Hemisphere crops, particularly in Australia. Australian wheat export accounted for 12% of world trade in 2013-14.

Global ending stocks for the current 2013-14 marketing year, which ends on May 31, are estimated at 26.4% of consumption. That's near the low end of the five-year average, but still well above the dangerously low levels we saw in the mid 2000s.

All the supply-side issues cited above present potential problematic scenarios. We advise establishing long positions in December wheat on a 30¢-per-bushel setback from any new high.

[By Sholom Sanik, May 6, 2014]

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Chart 1 – December wheat



Courtesy Bloomberg LP

CORN

Was the May USDA crop report *so* bearish?

Corn prices rallied by \$1 per bushel, or close to 25%, between January and early this month. Short- and long-term fundamentals appeared bullish for both the supply and demand sides. Sharply lower US acreage for the 2014-15 crop currently being planted, a strong export market, and uncertainty regarding the Ukrainian situation provided a sound bullish case (see *Focus on Futures*, April 8). The massive two-year-long slide from \$8 per bushel seemed to have ended. Then, the May 9 USDA monthly crop report brought an abrupt halt to the rally (Chart 2).

Old-crop US bullish fundamentals remained intact. To reflect the healthy pace of new commitments, the estimates for 2013-14 export sales were revised upwards by 150 million bushels, and ethanol usage was increased by 50 million bushels. The estimate for ending stocks was lowered to a season-low 1.146 million bushels, or 8.4% of consumption, down from the April estimate of 9.8%, and a far cry from early-season forecasts of 15.5% of consumption.

Acreage for the 2014-15 US crop is estimated to fall by 3.9% from the previous season – but that has been known since the March 30 planting intentions report. Although the estimate for record yields of 165.3 bushels per acre was not much of a surprise either, it was somewhat of a confirmation. It comes after USDA analysts have had a chance to look at planting progress. As of the most recent weekly crop progress report, 84% of the crop had been planted, compared with 73% last year at this time.

We believe that the USDA's exuberance could be a tad premature. While this year's planting weather has definitely been good, it is below the five-year average of 88%. In addition, while emergence is estimated at 49%, compared with last year's dismal 34%, it too is below the five-year average of 64% average. Perfect weather conditions would therefore be necessary to meet the USDA estimate.

Global old-crop ending stocks were revised higher by 10 million tonnes, due to increased estimates for the Brazilian crop, an increase in the estimate for 2012-13 ending stocks, and downwardly revised consumption. As a result, the estimate for ending stocks jumped to 17.8% of usage, up from the April estimate of 16.6% – the largest carryover in five years.

Global ending stocks for 2014-15 were substantially higher than expectations – and that is what really caught the street's eye. The USDA forecast ending stocks at 182 million tonnes, or 18.8% of usage, compared with the average guesstimate of 159 million tonnes.

Actually, production is estimated to be about the same as 2013-14, and consumption is expected to grow by 15 million tonnes. The increase is mostly the result of the upward revision to 2013-14 ending stocks. The major exporters are not expected to grow much larger crops than in 2013-14. So although we are looking at the potential for the largest ending stocks in five years, exportable surpluses will not grow.

Sceptics will argue that this is not an issue, because they

do not believe that the US will actually ship the mammoth commitments found on the books and that cancellations will emerge sooner or later as foreign buyers switch origins or hold out for cheaper prices. They cite weak early sales for the new crop year as evidence.

In the meantime, the pace of old-crop new sales has slowed down, but shipments have been quite strong, and there has been no indication that cancellations are on the horizon. With 15 weeks remaining in the marketing year, the USDA target of 48 million tonnes is still very much achievable.

As indicated earlier, domestic ethanol usage is still

growing, albeit at a more moderate pace than we've become accustomed to. Domestic feed consumption for 2013-14 was at its highest level in seven years.

The US remains the supplier of last resort. Although US ending stocks will finish 2013-14 at their highest level since 2010-11, as we pointed out above, that level was about 46% below early-season estimates. Until it becomes clear that a 165-bushel-per-acre estimate is realistic, we believe the market will find support.

Remain long December corn. Maintain stops at \$4.50 per bushel, close only, as per our April 8 recommendation.

[By Sholom Sanik, May 22, 2014]

Chart 2 – December corn



Courtesy Bloomberg LP

COCOA

Is this bull for real?

Cocoa prices are trading at three-year highs (Chart 3). The market is being driven by forecasts for a 2013-14 global deficit. The speculative community is exuberant about the bullish case – open interest is near record highs, and CFTC data show a growing net-long position of 58,000 contracts. As we will illustrate, however, recent developments for both supply and demand fundamentals do not necessarily support their bullish optimism.

The main-crop in the Ivory Coast is over, and we are well into the April-through-September mid-crop harvest. There were moments this season when weather threatened

to cap output at modest levels, but at this point there does not seem to be too much risk of a crop failure. After a strong early start, arrivals were running close to last year's output. As recently as early April, arrivals were only 8% ahead of last year. Port arrivals now stand at 1.47 million tonnes, up 18% from last year at this time. At this pace, the Ivory Coast is well on its way to a record crop

In Ghana, the world's second-largest producer, arrivals stand at 766,000 tonnes, up 16% from last year at this time. The spread over last year's output has also been inching up over the past two months. Ghanaian production is also set

to top early-season estimates of 820,000 tonnes, with recent forecasts at about 850,000 tonnes.

Another unexpected supply twist comes from Indonesia. Several months ago the crop was forecast at 425,000 tonnes but is now estimated to reach 500,000 tonnes.

Aside from the early-season weak supply forecasts, the underpinning of the rally – which began in January – was an expectation for growing demand. First-quarter grinding data were disappointing, though. European and North American grindings, reported in mid-April, rose 0.4% and 1.03%, respectively. That is far below the roughly 3% growth figure that has been used to arrive at the 2013-14 deficit forecasts.

A key indicator of demand, the butter ratio, has maintained its strength, at 2.62 times the London spot price. Powder prices, however, remain weak, which has left the combined ratio of the two main bean products at depressed levels (Chart 4).

According to the International Cocoa Organization (ICCO), the global market had a 193,000-tonne deficit in

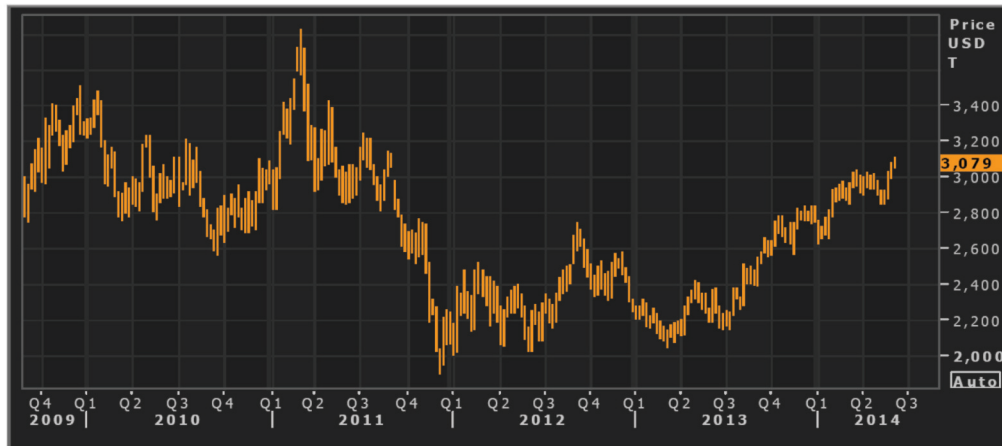
2012-13. Its early forecast for the current 2013-14 marketing year called for a 115,000-tonne deficit. Recently, the ICCO lowered its estimate to 75,000 tonnes.

The estimates for the current crop year, however, are based on production and grinding data that are probably stale. The spurt in output increases cited above is in all likelihood not accounted for. In addition, the ICCO still maintains that grindings are expected to grow by 2.7%. With the disappointing numbers for the first quarter, second-quarter grind results – due out in mid-July – would have to be extraordinary to maintain the integrity of the ICCO demand estimate.

We believe that the market is overvalued, the result of chart-following strategies that, at times, fail to recognize material shifts in underlying fundamentals. We are going to recommend a low-risk, but potentially very rewarding trade. Establish short positions in September cocoa, currently trading just above \$3,050 per tonne. Place initial stops at \$3,150, close only.

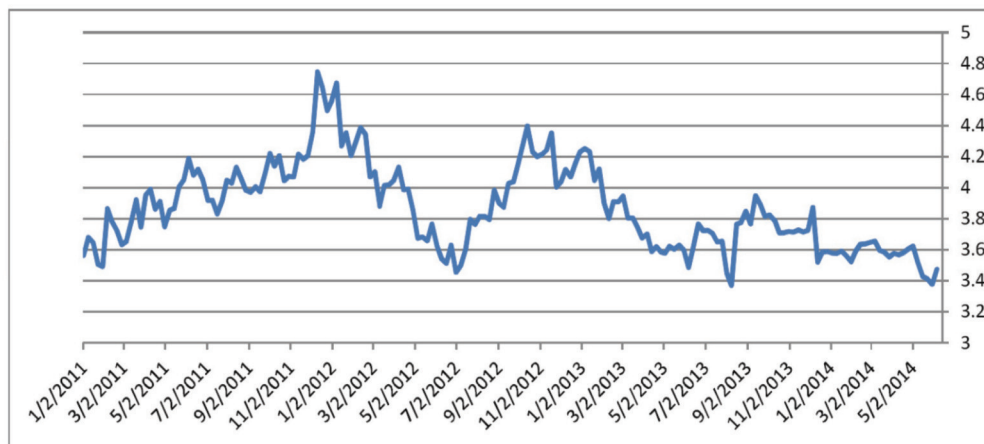
[By Sholom Sanik, June 9, 2014]

Chart 3 – Weekly nearest contract ICE cocoa



Courtesy Bloomberg LP

Chart 4 – Combined butter/powder ratio



COPPER

The bear is prowling

Although Chinese copper imports in May were 16% below the previous month, year-to-date purchases through the end of April were 33% higher than in the same period last year. Recent events, however, may threaten the longevity of the insatiable buying spree we've seen over the past year (Chart 5).

Prices dropped sharply this month (Chart 6) after a scandal was uncovered at China's Qingdao Port. Record-keeping at off-exchange warehouses in China is notoriously opaque. It seems that cargoes at the port in question were double counted – and beyond – and used to post collateral for financing deals multiple times for single cargoes. At issue is the possibility that banks would curtail financing for imports and, as a result, that the monstrous volumes of monthly copper imports would contract rapidly. This could indeed become a bearish factor.

Other barometers of global supply/demand fundamentals present mixed signals. Warehouse stocks have been falling and are now at multi-year lows. Combined stocks at LME, Shanghai, and COMEX stand at 270,000 tonnes, compared with 935,000 tonnes one year ago (Chart 7).

As stock levels plunged, backwardation on the LME rose to its highest level in two years. Normally, higher spot prices should encourage deliveries and result in higher exchange inventories. However, it was short lived because the backwardation quickly faded as prices came off (Chart 8). Stock levels at bonded warehouses in China are still said to hold 600,000 to 700,000 tonnes, although there is no official data to substantiate the amount. It's all a bit confusing, but the balance of evidence suggests that we cannot place too much weight on bullish warehouse data.

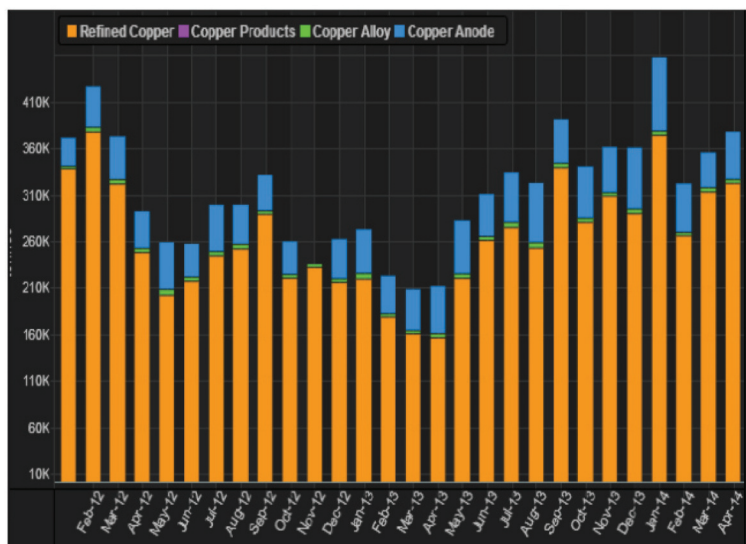
After several years of global deficits, The International Copper Study Group (ICSG) estimates that there will be a global copper surplus of 405,000 tonnes in 2014 and a 595,000 tonne surplus in 2015, citing primarily expanding mine output. There was a fair bit of fuss generated over the Indonesian export crisis, which seems close to being resolved. Any discussion regarding the supply side of copper outside of Chilean production, however, is near irrelevant. ICSG estimates Indonesian production at about 7.5% of the world total, compared with 33% for Chile (Chart 9). In 2013, Chilean production grew by 6.1%, and the government estimates that output will increase 5% in 2014. So far this year, average monthly output is up by 2.9% through the end of April.

Global demand and supply both grew by just over 4% in 2013. While economies in most regions continue to chug along, there has been nothing spectacular about recent economic data that would suggest that demand growth for copper could improve much. As illustrated, barring unforeseen circumstances, output growth should outstrip demand growth. With the possibility that Chinese imports may begin to sag, we believe this market could see much lower prices.

Having presented a mostly bearish case, we are not quite prepared to recommend a short position. The flow of Chinese imports – the single largest factor for copper prices – has been resilient despite slower economic growth. Indeed, any indication that Chinese imports are fading would be cause to act quickly and establish a short position. For the moment, though, stand aside.

[By Sholom Sanik, June 18, 2014]

Chart 5 – Monthly Chinese copper imports



Courtesy Bloomberg LP

Chart 6 – September copper



Courtesy Bloomberg LP

Chart 8 – LME spot/3-month copper spread

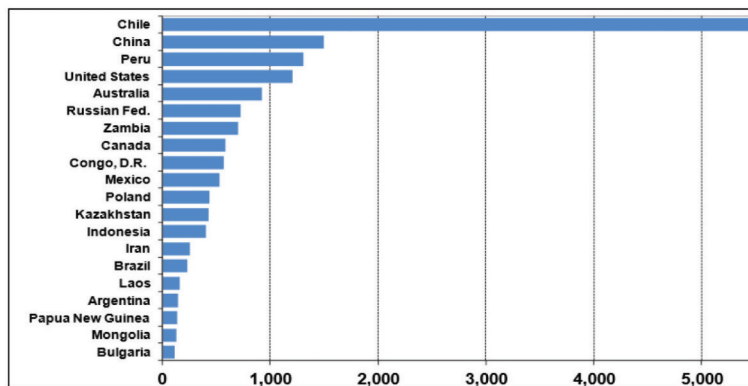


Courtesy Bloomberg LP

Chart 7 – Combined warehouse stocks



Chart 9 – Global copper production by country



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