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Sugar: ever so sweet

Sugar has rallied 3.5¢ per pound from its low in early March. The strength was sparked by evidence that the era of global production/consumption surpluses of the last half of the 1990s was coming to a close. The International Sugar Organization (ISO) first estimated that the surplus for 1999-00 would fall to 3.59 million tonnes from 6.51 million tonnes at the end of 1998-99. On May 18 it revised that by lowering the estimated surplus to 2.23 million tonnes. Poor crops in China and Brazil were the primary culprits. Has the steep rise in prices accounted sufficiently for the shift in the supply/demand balance?

More recent developments suggest that the shrinking 1999-00 surplus is just a taste of things to come. On May 26 the USDA gave us the first glance at what the 2000-01 season might look like for the sugar market. It estimates that world sugar production will drop by 6%, to 124.4 million tonnes. The big losses in output would come from Brazil (down 5.2 million tonnes, or 26%) and the European Union (down 2.5 million tonnes, or 13%). Despite its forecast for a drop in world trade of about 5 million tonnes, demand will continue to rise. The USDA estimates that global consumption will grow by 1%, to a record 129.5 million tonnes. This would leave the sugar market with a 5.1-million-tonne production/consumption deficit. Just three or four months ago, nobody would have believed that this market could turn around so quickly – from surplus to deficit.

As is the case with many commodities, the supply and demand dynamics of the Chinese market have the ability to influence the entire market. Consumption in China has been rising with a growing population. The average annual growth rate in consumption for the past five years is about 3%. The poor weather conditions that reduced output this past season by over 1.5 million tonnes have thrown a comfortably-supplied market into one on the brink of tightness.

Consider: At the end of the 1998-99 season, carryover stocks in China totaled 2.5 million tonnes, or 28% of consumption. At the end of this season, stocks will drop to 1 million tonnes, or 12% of consumption. If the USDA forecasts are accurate, stocks will fall even further by the end of the 2000-01 season, to 942,000 tonnes, or 10% of consumption. This tightness would appear even after accounting for a 12% recovery in Chinese production.

The bullish case seems rather convincing. Can anything go wrong? Some of the heavy international trade we've seen recently may dry up when the world's largest importer of sugar, Russia, implements its 40% import tax on June 15. Harder evidence of a slowdown can be seen in Thailand where traders report that only about half of the country's 4 million tonnes available for export has been sold.

On the technical side, the market is clearly heading into overbought territory. Others have taken note of the fantastic turnaround in the global supply/demand balance as well. The sentiment indicators that we look at have popped up to their highest reading for as far back as we can remember. Open

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

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interest has exploded to over 200,000 contracts, and has been higher only once before. Commitment-of-traders data indicate a very prominent presence of speculators on the long side, with commercials selling into the rallies.

We view the backup in Thai supplies in terms of sticker shock. The Chinese will almost certainly be buyers in the coming months. Yes, there will be setbacks to alleviate overbought conditions, but given the fundamentals, we are confident that this market has turned from bear to bull. *[June 2, 2000]*

CURRENT STRATEGY: *Remain long Sugar. Roll July to October. Maintain stops at 795, close only.*

Chart 1 – July Sugar (courtesy of *Reuters*)

GOLD

Gold's rally: dollar weakness or a whiff of inflation?

Gold prices began the month of June on familiar turf -- hovering near fresh, multi-month lows. Uninspired traders continued to focus on the usual negative fare such as pressure from central bank sales, low inflation rates, and the flow of investment dollars to equity markets that had been battered but still seemed to have plenty of life in them. The one item that had slipped off the radar screens of many participants was the significance of the relationship between the US dollar and the price of gold.

The dollar had been tracking the US economy and had been in a steady, long-term uptrend, gaining some 30% against major currencies like the euro and the yen, since late 1998. The first chink in the armor of the powerful economy started to appear in the form of some soft data at about the middle of May. The dollar faltered, with the trade-weighted dollar index slipping as much as 6.5% in a three-week period, its largest drop in quite some time (Chart 2). Gold prices had a bit of a delayed reaction but responded soon enough, shooting up about $20 per ounce.

Strength in gold prices is not wholly dependent on weakness in the dollar or vice versa. In fact, recent history bears such evidence. Earlier this year, when gold prices spiked by over $30 per ounce because some major producers covered part of their hedges, the dollar was busy making new highs. However, this month's rally in gold, in the absence of any other news of substance, was almost certainly tied to the sudden move in the dollar. Will the dollar remain weak? Are there any other reasons for gold prices to rise, and would those factors be strong enough to keep gold up if the dollar were to return to its winning ways?

Well, for starters we believe that, indeed, there is a very good chance that the dollar will not return to its winning ways. Many economists and analysts point to recent soft economic data such as retail sales and are working with ideas that the economy is softening, certainly vis-à-vis the European economies. This would spell an end to rising interest rates, which would in turn make the dollar less attractive.

In the days leading up to the May FOMC meeting, at which the Fed raised the Fed Funds Rate by 50 basis points (bps), the street was so enthusiastic about continued strength in the economy that it priced in a hike of yet another 50 bps. When the weak data began to show up, economists started to roll back their predictions for further aggressive tightening by the Fed to the extent that interest rate futures are now pricing in no move at all in the Fed Funds Rate for the June FOMC meeting (Chart 3). Many also point to the current account deficit that rose to a record $102 billion in the first quarter, which will also apply downward pressure on the dollar.

While we agree that the dollar does not look very healthy, we are not convinced that the years of economic expansion are going to end so easily, i.e., let Mr. Greenspan off the hook with a soft landing. We worry about some things that have not been popular to worry about in recent years, namely, inflation.

Commodity prices have broken out of their long bear market. The Bridge/Commodity Research Bureau (CRB) Index is up almost 25% in the past 11 months. Critics argue that a chart of the CRB Index (Chart 4) looks suspiciously like a chart of crude oil (Chart 5). The argument that surging oil prices may be temporary is valid and is in fact the very reason that governments report two inflation rates, one with volatile food and energy prices and one without.

Take note, however, that the May CPI report showed that the core rate that excludes food and energy rose by 0.2% compared with a 0.1% rise in the headline rate. The headline inflation rate (suspiciously) did not include a $4-per-barrel rise in the price of crude oil for the month of May. Still, despite the fact that it does not include the volatile components that comprise the CRB Index, the core

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rate managed to show an annual rate of increase of 2.3%, after starting the year at a rate of 1.5%.

Although still tame at these levels, prices stopped falling over a year ago, and have been nudging up gently since. The labor market remains tight as well. The gold market may very well be sniffing an even sharper increase in prices. Astute gold-market bulls may be looking into recent developments at a deeper level. They are betting that the Fed will probably acquiesce to the street's perception that it has tightened enough, which would exacerbate the problem by creating more easy credit and increase the risk of inflationary pressures.

In conclusion, we do believe that gold has its own legs. We were long this market, but our timing was far from perfect, having bought the breakout. As such, we maintained a cautious posture by using tight stops and were promptly stopped out. The first probe did not work, our powder is dry for a second try. The true test of the gold's mettle will come on corrective rallies in the US dollar. We're watching closely.

[June 22, 2000]

CURRENT STRATEGY: *Remain long August gold as per Flash Update of June 29. Place stops at 275, close only.*

Chart 2 – Dollar Index

Chart 3 – July Fed Funds

Chart 4 – CRB Index

Chart 5 – Spot Crude Oil

WHEAT

A bull market around the corner

We've been here before. Wheat prices approach the $3-per-bushel level only to be turned away. The market then drops sharply and threatens to break below the floor of the range (Chart 6). This pattern has persisted since the fall of 1998. Is the rally that began at the end of last year any different? A cursory glance at the chart does not offer a very optimistic forecast. The rallies have formed a series of declining peaks, and each new low was lower than the previous one – in a technician's parlance, that is a classic bear market formation.

The fundamentals, however, tell a different story. Both the supply and demand sides of the equation are becoming increasingly positive for prices. The June USDA supply/demand situation report shows that the world balance continues to tighten. World production was revised downwards by almost 5 million tonnes to 575 million

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tonnes, which in turn lowers projected ending stocks for 2000-01 to 106 million tonnes, or 17.8% of consumption. This will represent the lowest level of carryover stocks in the past 25 years.

The primary culprit is China. In the June report, the USDA lowered its estimate for the 2000-01 Chinese crop by 3 million tonnes from its previous forecast. The Chinese will produce only 104 million tonnes this year compared with 115 million tonnes in 1999-00. The combination of poor weather and switching of acreage to oilseeds has been responsible for the reduced output. For the 1998-99 season, Chinese imports had dried up to less than 1 million tonnes from as much as 12.5 million tonnes 5 years ago. Now the USDA estimates that China will import 3.5 million tonnes this year. Even though total consumption has remained fairly constant in China since 1997-98, the lower production factor is drawing stocks down to dangerously low levels.

In a special report on wheat released just the other day, Bill Gary of *Price Perceptions* points out that, measured in terms of days of supply, ending stocks will fall to below 60 days of supply compared with the five-year average of about 85 days of supply. This is the lowest level in modern history. Given this situation, we expect the Chinese to be good customers for wheat in the months ahead.

The bearish factor for wheat is the high level of stocks in exporting countries, particularly the US. Output has been in decline since the 1998-99 season when US farmers produced 69 million tonnes of wheat. The June USDA report showed 2000-01 output of 60 million tonnes. Since demand wasn't growing very much, ample carryover stocks were able to compensate for declining production during this period, and thus there was very little effect on prices.

Recent developments with US wheat crops, however, will almost certainly have some effect on 2000-01 ending stocks. Heavy rains will reduce both quality and yield. Monday's USDA crop progress report showed that the good-to-excellent portion of the winter wheat crop had declined again to 45% from 52% just a few weeks ago and 66% at the same time last year. Although the spring wheat represents only 25% of total US production, its health is vital in a market that is seeing production problems on both the domestic and global fronts. Only 64% of the spring wheat crop was rated in good-to-excellent condition, down from 67% last week, and compared with 74% last year.

The export market has been showing some signs of life as well. New sales of wheat in the past two weeks have been higher than street estimates and considerably higher than the trend of the past few months. Although in historical terms we're not off to a great start, sales are ahead of last year's pace.

Bears will argue that wheat prices have become too expensive relative to the price of corn to the extent that it is very uneconomical to feed wheat to livestock and that will stunt demand for wheat as a feedgrain. Chart 7, however, illustrates clearly that although wheat is trading at a ratio of 1.4 times the price of corn and is indeed expensive relative to the range of the ratio in the past few years, it is not overextended in broader historical terms.

In addition, the corn market has been so primed for a summer of drought that the recent unexpected rainfall has completely erased any premiums associated with the potential for any crop disappointment. Such optimism is a bit premature and corn prices are probably quite oversold at this juncture. Rallies in corn should bring the wheat/corn ratio back into line and keep wheat prices competitive as a feedgrain.

The supply side has been bullish for some time, and the demand side is coming around. Yes, the chart is saying "bear market rally", but the fundamentals are saying that this market is poised to rip the roof off the top of the two-year-old trading range. *[June 28, 2000]*

STRATEGY: *Stay* very closely *tuned.*

Chart 6 – Spot Wheat

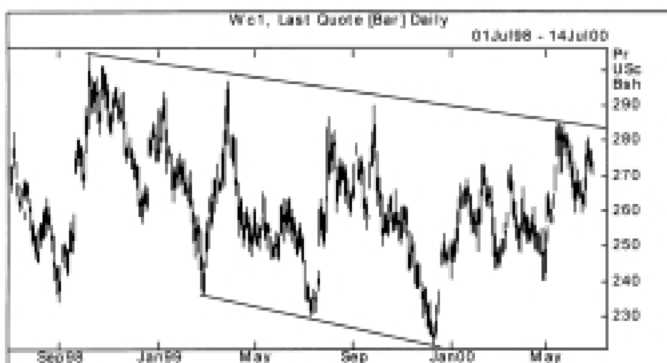
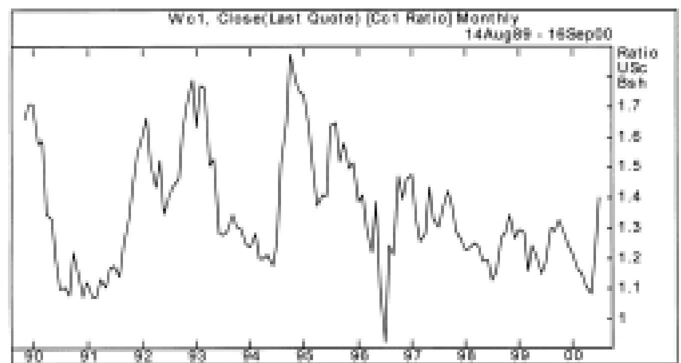


Chart 7 – Wheat/Corn Ratio



Charts courtesy of *Reuters*

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ROUNDUP

Commodity prices: still humming along

Commodity prices have turned around. This can certainly be said if we were to measure the general level of commodity prices in terms of the Bridge/Commodity Research Bureau Index (CRB). The index made a new recovery high at 227 just the other day. It has now recovered over half its losses since the index began to slide in the spring of 1996.

Energy prices lead the way with the prices of crude oil and natural gas tripling in price. The livestock sector carried the torch for some time, and grains have had their moments too.

In a broad sense, the foundation of the rally makes much sense. Strong economies in the developed and developing world have reignited demand for everything from basic foodstuffs (grains, meats) to luxury commodities (cocoa, platinum) to industrial materials (platinum again, other base metals, and of course, petroleum).

The simple, maintenance-free strategy that takes advantage of the general trend of rising commodity prices is to be long the CRB Index. Although the index posted a new high, in essence it has made little progress since the middle of May. Skeptics could argue that since many economists believe that the good times have reached a plateau, the same may hold true for commodity prices whose strength was fueled by rampant economic growth. In a sense, the Fed underwrote this notion this week by holding the Fed Funds Rate unchanged.

We believe that the effects of years of expansive monetary policy will keep nominal incomes growing, which will maintain strong consumer spending patterns that will ultimately result in inflationary pressures. We therefore believe that the Fed may have been somewhat premature in halting the series of interest rate hikes. So, while we have taken some precaution by nudging our CRB stop up towards the market periodically, we our comfortable with being long commodities. With very similar reasoning, we have also reentered the long side of the gold market.

Nonetheless, trading markets armed only with macroeconomic fundamentals cannot compete with trading with intimate knowledge of the supply and demand dynamics of individual commodities. The two commodities that we've been following closely and have been able to maintain long positions in are platinum and sugar. We remain bullish on both. The following is a brief overview and update of these two markets:

Sugar

In recent weeks there has been an overwhelming consensus among commodity analysts that could be found in just about anything you read about sugar. Everyone seemed to agree that the sugar market was so overbought that a correction was imminent. Well, there was a correction, but as corrections go, this one was not spectacular. It was small in both magnitude (less than 1¢ per pound) and duration (two days). The dip was probably associated with fears of what might happen to international trade after Russia imposed its import tax on June 15, which was designed to stimulate the domestic market. But as the July contract expires, the market is powering through the 9¢ level to new contract highs. We have not seen 9¢ sugar since the summer of 1998.

On Wednesday, India, the world's largest producer and consumer of sugar, announced that it would begin exporting sugar in a few weeks. As its harvest draws to a close, it is estimated that it will have produced a bumper crop of 18.2 million tonnes for the 1999-00 season. This is up about 1 million tonnes from previous estimates and a dramatic comeback from a very poor crop of 15.5 million tonnes in 1998-99. This, however, is about the only bearish news for sugar prices, aside from the Russian import tax, which seems to have passed thus far without much impact on world prices.

On the same day that India announced its intention to begin exporting its bountiful crop, another item came across the wire that was even more bullish than the Indian news was bearish. It was confirmed that output in the countries of the European Union for the 2000-01 season would fall sharply to just over 15 million tonnes compared with production of 17.66 million tonnes in 1999-00, primarily because of poor growing conditions.

At the beginning of the 1999-00 season, it was believed that we would end the year with a global surplus of about 6 million tonnes. Estimates shrank as the season progressed until we were left with a surplus of just over 2 million tonnes. As we look ahead to the 2000-01 season, the production/consumption balance will turn to deficit. At this point, it is too early to expect any precision from crop forecasts (the average estimate for the world crop between the USDA and F.O. Licht is for a drop of 7%). Consumption will likely grow by about 1%, leaving a deficit of about 5 million tonnes.

This market is in transition from bear to bull market. Prices are still cheap in both historical terms and in relation to their cost of production. The latter is the key, because at these prices, farmers (in countries where sugar production is not subsidized) will not be eager to increase output. It has been a classic bear market. But it's over.

Platinum

Since the middle of last year, most discussion concerning platinum revolved around the Russian law that kept exports from leaving the country. And rightfully so, considering that Russia is (was?) the provider of 20% of world supplies of this vital industrial component. Now, here we are, many months after the law that repealed the earlier one passed, and still no platinum. Platinum from Russia has trickled out, but the difference between the 800,000 ounces that it allegedly had available for exports and the 540,000 that Johnson Matthey originally estimated it would ship has still not been spotted.

We were led to believe that all legislative roadblocks had been cleared, export licences had been signed, and whatever else it would take to ship the platinum had been seen to. It was quite amazing, then, to see a report out of Russia Thursday morning that quoted the chairman of the central bank complaining that it had not yet been given a licence to

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export platinum group metals. Draw your own conclusions. Ours is simple: When we see it, we'll believe it exists.

In the meantime, the market is making new highs. One-month lease rates have come down from about 60%, but remain steady at a still very high 35%. Open interest remains low, both in New York and Tokyo, indicating that the strength is still not being generated by speculation. On the contrary, the speculative dollars may very well be on the sidelines, and the best is yet to come. *[June 30, 2000]*

STRATEGY: *Remain long August CRB. Raise stops to 218, close only.*
Roll July sugar to October. Maintain stops at 7.95, close only.
Roll July platinum to October. Place stops at 519, close only.
Remain long August gold as per Flash update of Thursday, June 29. Maintain stops at 275, close only.

HOTLINE UPDATE

Friday, June 2, 2000
Good afternoon for Friday, June 2, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long July sugar, with our stop at 6.80; long June CRB Index, with our stop at 216; long July cocoa, with our stop at 770; long July platinum, with our stop at 470; and long July wheat, with our stop at 267. All stops are close only.

Flash Update: **Monday June 5, 2000**
Good Afternoon for Monday, June 5, 1:15 am. This is a Flash Update. We have liquidated our long July wheat position at 265.

Friday, June 9, 2000
Good afternoon for Friday, June 9, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long July sugar, with our stop revised to 7.50; long July cocoa, with our stop revised to 795; long July platinum, with our stop revised to 509; and long August CRB Index, with our initial stop at 216. All stops are close only.

Flash Update: **Thursday, June 15, 2000**
Good morning for Thursday June 15, 9:00 am. This is a Flash Update. We have purchased August gold at 291.20, placing our initial stop at 282, close only.

Flash Update: **Friday, June 16, 2000**
Good morning for Friday June 16, 10:00 am. This is a Flash Update. We have two new recommendations. We have liquidated long July cocoa at 853, and purchased September S&P, currently trading at 1501, placing our initial stop at 1451.50, close only.

Friday, June 16, 2000
Good afternoon for Friday June 16, 5:10 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long July sugar, with our stop at 7.50; long July platinum, with our stop revised to 515; long August CRB Index, with our stop at 216; long August gold, with our initial stop at 282; and long September E-Mini S&P, with our initial stop at 1451.50. All stops are close only.

Flash Update: **Thursday, June 22, 2000**
Good afternoon for Thursday, June 22, 2:30 pm. This is a Flash Update. We have liquidated our long August gold position at 286.50.

Flash Update: **Thursday, June 22, 2000**
Good afternoon for Thursday, June 22, 3:10 pm. This is a Flash Update. We have liquidated our long September S&P position at 1475.

Friday, June 23, 2000
Good afternoon for Friday, June 23, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long July sugar, with our stop revised to 7.95; long July platinum, with our stop revised to 531; and long August CRB Index, with our stop at 216. All stops are close only.

Flash Update: **Thursday, June 29, 2000**
Good morning for Thursday July 29, 9:20 am. This is a Flash Update. We have purchased August gold at 284, placing our initial stop at 275.00, close only.

Flash Update: **Thursday, June 29, 2000**
Good morning for Thursday July 29, 11:00 am. This is a Flash Update. We have rolled over our long July sugar position, selling July sugar at 880, and purchasing October at 879. We repeat our Flash Update of this morning, where we purchased August gold at 284, placing our initial stop at 275.00, close only.

Flash Update: **Friday, June 30, 2000**
Good morning for Friday, June 30, 10:10 am. This is a Flash Update. We have rolled over our long platinum position, selling July at 560, and buying October at 546.

Friday, June 30, 2000
Good afternoon for Friday, June 30, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long August CRB Index, with our stop revised to 218; long August gold, with our initial stop at 275; long October sugar, with our stop at 7.95; and long October platinum, with our new stop at 519. All stops are close only.

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Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1901
New York, N.Y. 10005
(212) 943-5300

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