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COMMODITY & CURRENCY COMMENTS FOCUS ON FUTURES

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Yes, Fed-administered interest rates are set to rise, but is the carry trade dead?

It's been no secret that the carry trade (that is, funding long-term, high-yielding securities with short-term money) has been spectacularly successful for the past few years. Are there any profits left to be squeezed even as Fed funds are certain to begin an upswing? Or, more simply, will long-term bonds stabilize at these levels?

The answer is crucially dependent on two things: the shape of the yield curve and the durability of the new economic paradigm.

Let's start with the yield curve. As of this past Friday and following on the heels of a blowout employment report, futures prices of Eurodollars anticipated a 110-basis-point (bp) rise in short rates by December of this year and a *further* 157 bp increase by December 2005. On the assumption that the rise in rates takes this path, it remains quite profitable to carry a 10-year security yielding 4.77% and even more profitable to carry a 30-year security yielding 5.45%. But will the rate rise take this path?

Arguing for a yes answer to this question, we list a number of factors. First, the Fed has indicated that it will move in "measured" steps. This has been taken to mean 25 basis points at a time. The Fed's resident academic and intellectual powerhouse, Governor Ben S. Bernanke, in a recent address delivered at the University of Washington, Seattle, adduced a number of strong reasons for this kind of gradual reaction. They were as follows: 1) policymakers' uncertainty about the economy; 2) gradualism in adjusting the policy rate affords policymakers greater influence over the long-term interest rates that most affect the economy; and 3) gradualism reduces risk to financial stability.

With respect to 1) above, Bernanke concluded that "empirical studies and simulations of realistic economic models suggest that, normally, relatively gradual policy adjustments produce better results in an uncertain economic environment" and that "in practice...a desire on the part of

policymakers to be conservative in the face of many different forms of uncertainty is probably an important reason for gradualism in monetary policy."

Bernanke disagreed with those who criticized the Fed for being behind the curve: "A given level of the funds rate can be consistent with easing or tightening monetary conditions, depending on market expectations about future short-term rates. In part because of the FOMC's communication strategy, which has linked future rate changes to the levels of inflation and resource utilization, and in part because of the gradualist policies that the FOMC has pursued in the past, markets have responded to recent data on payrolls, spending, and inflation by bringing forward a considerable amount of future policy

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Contributions by Albert D. Friedberg, Sholom Sanik, Chris Bennett, and Serhan Cevik.

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tightening into current financial conditions. Notably, in the past few months, long-term interest rates have risen 100 basis points or more, equity markets have been subdued despite robust earnings reports, and the dollar has strengthened. These developments – the sort of ‘front-loading’ of monetary tightening predicted by our analysis of gradualism – will reduce the financial impetus being provided to the economy and thus provide some check to nascent inflationary pressures.”

Secondly, adaptive behavior has already priced in most if not all the tightening foreseen at this point in time. For example, prior to the Fed’s tightening in February 1994, bond yields increased only 60 basis points. In contrast, today bond yields have already increased 130 basis points, and the Fed has not begun, as yet, to raise rates.

Moreover, a comparison of the ISI’s Institutional Bond Managers Survey of late 1993 with its recent survey shows managers long their duration (108%) then and short their duration (97.4%) now, implying that the coming rise in rates has been extremely well advertised.

In terms of magnitude – recall that today’s bond yields are lower than any time in the past – the trough-to-peak percentage change in yields in the recent selloff has been greater than the average of the past eight bear markets and almost equal to their two highest readings. It can also be seen that the duration of this move has been accomplished in less time than average, testimony to the market’s quickening learning curve (see Chart 1). Moreover, Chart 2 suggests that consumers, investors, and speculators are already positioned better than ever for higher rates.

Third, the new economic paradigm that features high productivity, increased competition via globalization, and the anchoring of inflationary expectations hold out the hope for a “lower high” in inflation rates compared with past recoveries.

In connection with anchoring, it is interesting to note that a recent study [Levin, Andrew T.; Natalucci, Fabio M; and Piger, Jeremy M. “The Macro-economic Effects of Inflation Targeting,” *Federal Reserve Bank of St. Louis Review*, July/August 2004, 86(4) (forthcoming)] found that inflation targeting affects the public’s expectations about inflation. Under an inflation-targeting regime, expectations about inflation, particularly at longer horizons, should be “anchored” by the target, and this should be less affected by changes in actual inflation.

Chart 3 shows how the public’s expectations of future inflation (5 and 10 years out) would change in the face of a 1 percentage point increase in average realized inflation over the preceding three years. Note the smallness of the response in the inflation targeting countries (Australia, Canada, New Zealand, Sweden, and United Kingdom).

Although the US, Japan, and the Euro area do not target inflation formally, and therefore the response is greater, private economic agents are well aware of their central banks’ discomfort with inflation rates exceeding 2%. In sum, the

anchoring phenomenon speaks meaningfully to the formation of inflationary expectations and suggests that one-time bumps, occasioned by oil price increases are not likely to be built into long-term expectations. Of course, this patiently constructed goodwill can dissipate rapidly if central bank action is not seen to be taken quickly and responsibly.

Adding to the bullish scenario painted here is the recent behavior of commodity prices. The 95% rise in the Goldman Sachs commodity index since November 2001 represents the sharpest percentage increase over the same time span since 1978. A recession ensued after every such spike (Chart 4), although one marvels at the relatively benign impact commodity prices have had on consumer prices in the recent cycle.

Nevertheless, there is still a fair chance that at the very least, a slowdown will follow the most recent spike. In the meantime, pressure on wholesale prices should abate soon in line with a broad stabilization of commodity prices, owing principally to a sharp deceleration in Chinese buying (see Baltic freight rates, Chart 5).

What is the downside to this relatively constructive scenario for bondholders?

For one thing, the new paradigm unravels for a number of reasons, taking the Fed and the market by surprise. As it is, we seem to be priced for perfection: Fed funds have been allowed to trade 500 basis points below nominal GDP, an historic negative spread.

For another, Asian inflation is clearly on the rise. If not brought under control soon (and we note China’s reluctance to tighten money), the benefits of import competition will be lost, and upward pressure will be exerted on domestic US prices. Also, while monetarism seems to have been discarded by the Fed as a factor in inflationary pressures, the recent spurt in monetary aggregates should not be ignored. There is a limit to the increase in the demand for money. One should not take for granted the notion that demand can absorb at unchanged prices all the money that is thrown at it.

The Fed and the market are traveling in uncharted waters. The emergence and durability of the new economic paradigm mentioned earlier will be put to test in coming months. Both players are betting on the continuation of the very favorable set of circumstances that have witnessed global inflation fall to very low levels in recent years. We need to be alert, however, because we do not know enough about the dynamics of inflation.

We are prepared to say that *given the present state of information about the economy and inflation*, the market seems to have already anticipated the full tightening cycle. One should expect therefore that most or all of the impact of rising Fed funds rates on the market will fall on the shape of the yield curve rather than on the level of long-term interest rates. Specifically, the yield curve will tend to flatten. This scenario augurs well for long-term bonds and thus for the carry trade.

Chart 1 – Putting the bond bear in a historical perspective

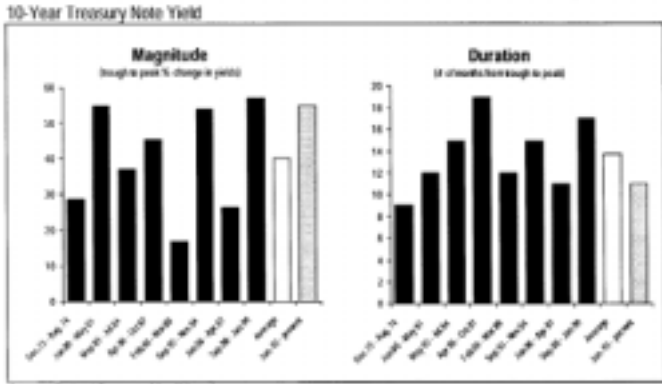


Chart 4 – GS Commodity Index

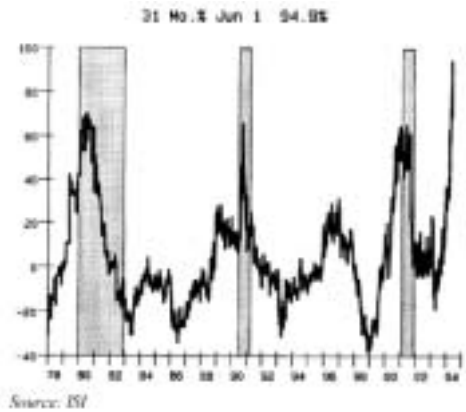


Chart 2



Chart 5 – Baltic Dry Index

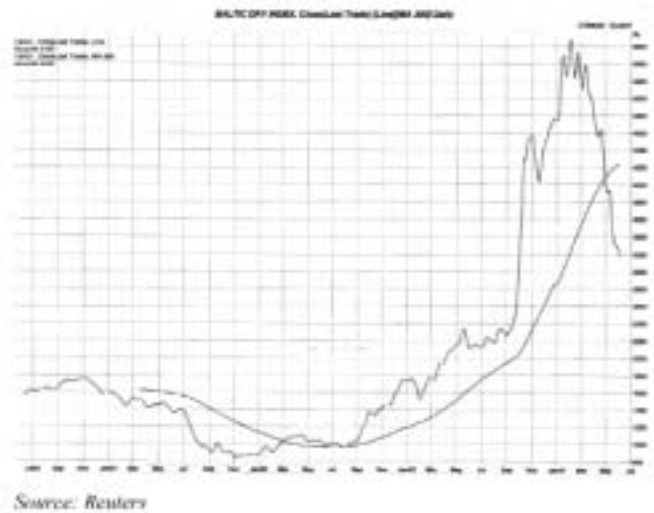


Chart 3 – Estimated response of inflation expectations...

Estimated Response of Inflation Expectations to Change in Realized Inflation

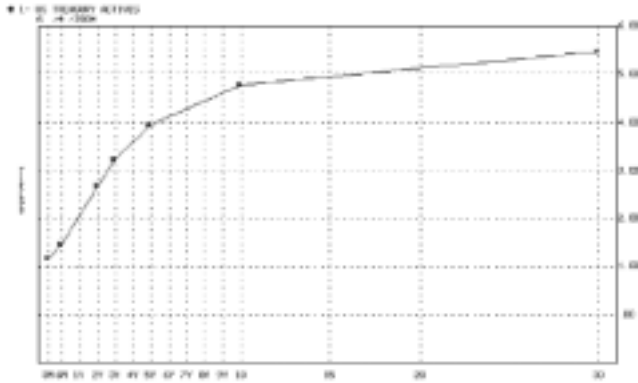
	Horizon of inflation expectations (years ahead)	
	5	10
Australia, Canada, New Zealand, Sweden, United Kingdom	0.09%	0.01%
Euro area, Japan, and United States	0.29%	0.24%
Euro area and United States	0.34%	0.24%

Source: Monetary Trends, The Federal Reserve Bank of St. Louis

Chart 6 – US Treasury 30-year bond futures perpetual chart



Chart 7 – Yield curve, as of June 4, 2004



Courtesy Bloomberg

Chart 8 – TIPS, 3 3/8% of 2032



Courtesy Bloomberg

CRUDE OIL

More fear than underproduction

By Chris Bennett

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According to the International Energy Agency, in the first quarter of this year, output is running ahead of consumption plus stock changes to the tune of 1.2 mm barrels per day.

It should be noted that non-Opec production is forecast to rise by 2.3 mm barrels per day (led by the Soviet Union's remarkable increase of 1.7 mbd) between 2002 and 2004, while Opec production rose 3.3 mbd in the two years to April 2004. China accounted for the single largest rise in consumption over the same period, 3.6 mbd, or 36 % of the overall increase.

Despite favorable supply/demand balance, speculative demand, based on fears that Saudi output could be interrupted by increased terrorist activities, has driven prices to new, multi-year, highs.

These fears will continue to exert pressure on prices for many years to come, resulting in a higher nominal price plateau than anticipated just two years ago. Dramatic spikes cannot be discarded, especially if fears about the fall of the Saudi House materialize or if a regional war engulfs the Middle East.

Still, oil is likely to follow the path of every commodity the world has ever used: falling real prices. Bjorn Lomborg, Associate Professor of Statistics in the Department of Political Science of the University of Aarhus, Denmark, in a marvellously researched book, *The Skeptical Environmentalist* (p. 135), writes: "At \$40 a barrel...shale oil can supply oil for the next 250 years at current consumption. And all in all there is oil enough to cover our total energy consumption for the next 5000 years..."

Today's prices are 60% lower in real terms than at their peak in the '70s. Tomorrow's prices are certain to be 80% and 90% lower in real terms. New supplies or substitution will do the trick.

We present without comment the following article. It makes for fascinating reading.

About 80 miles off of the coast of Louisiana lies a mostly submerged mountain, the top of which is known as Eugene Island. The portion underwater is an eerie-looking, sloping tower

jutting up from the depths of the Gulf of Mexico, with deep fissures and perpendicular faults which spontaneously spew natural gas. A significant reservoir of crude oil was discovered nearby in the late '60s, and by 1970, a platform named Eugene 330 was busily producing about 15,000 barrels a day of high-quality crude oil.

By the late '80s, the platform's production had slipped to less than 4,000 barrels per day, and was considered pumped out. Done. Suddenly, in 1990, production soared back to 15,000 barrels a day, and the reserves which had been estimated at 60 million barrels in the '70s, were recalculated at 400 million barrels. Interestingly, the measured geological age of the new oil was quantifiably different than the oil pumped in the '70s.

Analysis of seismic recordings revealed the presence of a "deep fault" at the base of the Eugene Island reservoir, which was gushing up a river of oil from some deeper and previously unknown source.

Similar results were seen at other Gulf of Mexico oil wells. Similar results were found in the Cook Inlet oil fields in Alaska. Similar results were found in oil fields in Uzbekistan. Similarly in the Middle East, where oil exploration and extraction have been underway for at least the last 20 years, known reserves have doubled. Currently there are somewhere in the neighborhood of 680 billion barrels of Middle East reserve oil.

Creating that much oil would take a big pile of dead dinosaurs and fermenting prehistoric plants. Could there be another source for crude oil?

An intriguing theory now permeating oil company research staffs suggests that crude oil may actually be a natural inorganic product, not a stepchild of unfathomable time and organic degradation. The theory suggests there may be huge, yet-to-be-discovered reserves of oil at depths that dwarf current world estimates.

The theory is simple: Crude oil forms as a natural inorganic process which occurs between the mantle and the crust, some-

where between 5 and 20 miles deep. The proposed mechanism is as follows:

- * Methane (CH₄) is a common molecule found in quantity throughout our solar system – huge concentrations exist at great depth in the Earth.

- * At the mantle-crust interface, roughly 20,000 feet beneath the surface, rapidly rising streams of compressed methane-based gasses hit pockets of high temperature causing the condensation of heavier hydrocarbons. The product of this condensation is commonly known as crude oil.

- * Some compressed methane-based gasses migrate into pockets and reservoirs we extract as “natural gas.”

- * In the geologically “cooler,” more tectonically stable regions around the globe, the crude oil pools into reservoirs.

- * In the “hotter,” more volcanic and tectonically active areas, the oil and natural gas continue to condense and eventually to oxidize, producing carbon dioxide and steam, which exits from active volcanoes.

- * Periodically, depending on variations of geology and Earth movement, oil seeps to the surface in quantity, creating the vast oil-sand deposits of Canada and Venezuela, or the continual seeps found beneath the Gulf of Mexico and Uzbekistan.

- * Periodically, depending on variations of geology, the vast, deep pools of oil break free and replenish existing known reserves of oil.

There are a number of observations across the oil-producing regions of the globe that support this theory, and the list of proponents begins with Mendeleev (who created the periodic table of elements) and includes Dr. Thomas Gold (founding director of Cornell University Center for Radiophysics and Space Research) and Dr. J.F. Kenney of Gas Resources Corporations, Houston, Texas.

In his 1999 book, “The Deep Hot Biosphere,” Dr. Gold presents compelling evidence for inorganic oil formation. He notes that geologic structures where oil is found all correspond to “deep earth” formations, not the haphazard depositions we find with sedimentary rock, associated fossils or even current surface life.

He also notes that oil extracted from varying depths from the same oil field have the same chemistry – oil chemistry does not vary as fossils vary with increasing depth. Also interesting is the fact that oil is found in huge quantities among geographic formations where assays of prehistoric life are not sufficient to produce the existing reservoirs of oil. Where then did it come from?

Another interesting fact is that every oil field throughout the world has outgassing helium. Helium is so often present in oil fields that helium detectors are used as oil-prospecting tools. Helium is an inert gas known to be a fundamental product of the radiological decay of uranium and thorium, identified in quantity at great depths below the surface of the earth, 200 and more miles below. It is not found in meaningful quantities in areas that are not producing methane, oil or natural gas. It is not a member of the dozen or so common elements associated with life. It is found

throughout the solar system as a thoroughly inorganic product.

Even more intriguing is evidence that several oil reservoirs around the globe are refilling themselves, such as the Eugene Island reservoir – not from the sides, as would be expected from cocurrent organic reservoirs, but from the bottom up.

Dr. Gold strongly believes that oil is a “renewable, primordial soup continually manufactured by the Earth under ultrahot conditions and tremendous pressures. As this substance migrates toward the surface, it is attached by bacteria, making it appear to have an organic origin dating back to the dinosaurs.”

Smaller oil companies and innovative teams are using this theory to justify deep oil drilling in Alaska and the Gulf of Mexico, among other locations, with some success. Dr. Kenney is on record predicting that parts of Siberia contain a deep reservoir of oil equal to or exceeding that already discovered in the Middle East.

Could this be true?

In August 2002, in the “Proceedings of the National Academy of Sciences (US),” Dr. Kenney published a paper, which had a partial title of “The genesis of hydrocarbons and the origin of petroleum.” Dr. Kenney and three Russian coauthors conclude:

“The Hydrogen-Carbon system does not spontaneously evolve hydrocarbons at pressures less than 30 Kbar, even in the most favorable environment. The H-C system evolves hydrocarbons under pressures found in the mantle of the Earth and at temperatures consistent with that environment.”

He was quoted as stating that “competent physicists, chemists, chemical engineers and men knowledgeable of thermodynamics have known that natural petroleum does not evolve from biological materials since the last quarter of the 19th century.”

Deeply entrenched in our culture is the belief that at some point in the relatively near future we will see the last working pump on the last functioning oil well screech and rattle, and that will be that. The end of the Age of Oil. And unless we find another source of cheap energy, the world will rapidly become a much darker and dangerous place.

If Dr. Gold and Dr. Kenney are correct, this “the end of the world as we know it” scenario simply won’t happen. Think about it...while not inexhaustible, deep Earth reserves of inorganic crude oil and commercially feasible extraction would provide the world with generations of low-cost fuel. Dr. Gold has been quoted saying that current worldwide reserves of crude oil could be off by a factor of over 100.

A Hedberg Conference, sponsored by the American Association of Petroleum Geologists, was scheduled to discuss and publicly debate this issue. Papers were solicited from interested academics and professionals. The conference was scheduled to begin June 9, 2003, but was canceled at the last minute. A new date has yet to be set.

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TURKEY

Turkey: a great convergence trade

By Serhan Cevik

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In our fund shareholders' letters, we have talked about our bullish outlook for Turkey, one of the few, perhaps the only, country in the world presently making a full transition to a liberal democracy. Its strategic political and geographic position, institutional improvements in the offing, and cheap labor costs make Turkey an extremely attractive investment proposition. Below, we present a brilliant political and economic analysis of this awakening giant.

Institutional reforms should cause the change of an agrarian community into a liberal society. The nineteenth-century German sociologist Ferdinand Tönnies differentiated between *gemeinschaft* – a community based on a shared sense of identity – and *gesellschaft* – a society with formal institutions facilitating the realization of instrumental goals – as basic forms of social integration. *Gemeinschaft* characterises closed, agrarian communities with a network of informal relations based largely on direct contacts. *Gesellschaft*, on the other hand, is the structure of laws and regulations that characterizes urban, contract-based, industrial societies. Turkish society has always been on the *gemeinschaft* side of this societal spectrum, but we believe that institutional reforms required for the integration with the European Union have unambiguously accelerated its transition from *gemeinschaft* to *gesellschaft* – an evolution from a feudal, agrarian system to a democratic, post-industrial society.

Turkey's institutional backwardness is a legacy of the bureaucratic Ottoman Empire. In our view, the legacy of the centralised bureaucratic Ottoman Empire was one of the key factors delaying the development of liberal democracy and market economy in Turkey. The patrimonial state structure restrained market-driven economic production, inhibited the rise of an independent mercantilist class, and therefore led to the development of a rent-seeking political economy. Although the republican leadership aimed to modernize the country, the new regime's development strategy remained state-centric and exceptionally gradual in terms of economic and political liberalisation. In fact, the state's role in all realms of the society has increased over time, as the hegemonic constitutions put greater emphasis on "national" unity and individuals' obligations toward the state, rather than protecting citizens against state intrusion. Particularly, the 1982 constitution, written by the military regime, severely restricted civil liberties and human rights, expanded the military's role in politics, and indeed reversed most of the democratic gains. Consequently, despite the development of an industrialised economy, Turkey's institutional framework remained illiberal, agrarian and out of sync with modern, post-industrial realities.

Dysfunctional institutions limit the country's productivity and potential growth. Earlier attempts, such as the transition to "electoral democracy" in the 1950s and economic liberalisation in the 1980s, actually yielded populism and clientalism, mainly because the authorities failed to tackle the prevailing statist and feudal socioeconomic structures. As a result, the emergence of a multi-party regime has not mechanically evolved into liberal

democracy. In reality, political fragmentation, giving rise to corruption and clientalist behaviour, social unrest, and regrettable military coups, had kept Turkey inward-looking with just a procedural democratic system.

Moreover, the relations between business and the state have remained as *gemeinschaft*-type networks encouraging rent-seeking behaviour and (re)distributive coalitions, as the political "elite" continued neglecting structural reforms addressing democratic deficits and the needs of a modern, open economy. In other words, dysfunctional institutions of a fragmented political regime have allowed potential losers to effectively block institutional change and thereby limited the country's productivity and potential growth.

Institutional factors play a central role in determining a country's rate of economic growth. Douglass North, a recipient of the Nobel Prize in Economics, suggested that it is the incentive structure imbedded in the institutional structure of countries that must be the key to solving the mystery of unequal and unpredictable economic growth. Indeed, institutional constraints that foster distortionary policies and worsen economic vulnerabilities account for a significant part of cross-country differences in economic growth and output volatility (see Daron Acemoglu, Simon Johnson, and Yuyong Thaicharoen, "Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth," *Journal of Monetary Economics*, January 2003). Not surprisingly, given its structural problems, Turkey's output volatility, measured by the standard deviation of the growth rate of per capita GDP, increased from an average of 2.43 in the 1970s to 2.70 in the 1980s to 5.37 in the 1990s, and to 7.28 in the last four years. However, as indicated by an IMF study, improving institutional quality by one standard deviation would lower the volatility of growth by over 25%, on average, and imply an increase of 1.4 percentage points in annual growth in real per capita income.

Institutional inertia could be punctuated by reforms required for the EU accession. It is clear that sustainable growth and development depend on the existence of sound institutional arrangements, but how does an appropriate pattern of institutions come about? According to the neoclassical theory, just as competition working through the market, institutions that are conducive to growth will evolve through "natural" selection. But, the problem with the biological analogy is that people can choose between institutions and as a result, unfavourable arrangements may survive over long periods. In fact, the Turkish experience shows that individuals and organisations with bargaining power, stemming from the existing institutional setting, have crucial stakes in perpetuating the system and thus impede institutional adjustments. Hence, an external anchor – such as the EU accession process – actually helps by eliminating institutional inertia and reducing the cost of developing modern social configurations.

The prospect of EU accession is a robust catalyst of institu-

tional makeover. Institutional change is typically incremental, but the EU accession process entails a rapid transformation of every aspect of the society. Candidate countries must meet certain standards in terms of political, economic, administrative, and legal institutions and civil society to become a member of the EU. Needless to say, the prospect of EU accession encourages broad-ranging institutional reforms that assist candidates to develop a well-functioning market economy and institutional capabilities to deal with the legal obligations of EU membership. This is why the EU anchor is overwhelmingly stronger, compared to all other arrangements, in facilitating institutional change. For example, the European Bank for Reconstruction and Development's transition indicator, which measures progress in market liberalization, privatisation and restructuring, and financial sector reform, shows much faster structural adjustment among the accession candidates than in other transition countries. Furthermore, accession countries develop higher-quality institutions, compared to others at comparable income levels, yielding a "growth bonus" equivalent to 24-36% of GDP (see Daniel Piazolo, "Growth Effects of Institutional Change and European Integration," *Economic Systems*, December 1999).

The Turkish society is undergoing a neo-liberal transformation. Following decades of sporadic progress, we have recently witnessed an impressive pace of institutional convergence in Turkey towards European standards. Political consolidation after the 2002 elections has permitted the introduction of far-reaching restructuring measures, abolishing ideological and dirigiste dogmas and prompting a paradigm shift in institutional development. The so-called "harmonisation" reforms, ranging from improving civil liberties and human rights to demilitarising the political domain, may not be entirely adequate at this stage, but clearly address major issues and, more importantly, highlight a growing consensus in favour of liberal democracy and announce the end of the state-centric governing philosophy that has blocked Turkey's economic and institutional advancement.

Turkey will benefit enormously from institutional predictability and the rise of liberal democracy. In addition to legislative reforms addressing political issues and structural reforms under the auspices of the IMF and the World Bank dealing with the country's economic problems, we also expect to see a comprehensive public administration reform aiming to improve the quality of governance. Given that the impact of institutional improvements on growth is strongest for countries starting from a lower level of institutional development, Turkey has great potential for restructuring and growth catch-up that has been repressed by an under-developed legal and institutional environment. In our opinion, the Turkish economy will benefit enormously from institutional adjustments and the development of liberal democracy, which, as the EBRD data illustrate, is a key for maintaining the virtuous circle of institutional change. Furthermore, a highly developed institutional framework that is relatively insulated from political tinkering can bring the economy close to its first-best efficient outcome.

Structural reforms have already lessened the traditional Turkish dirigisme. Structural adjustments have already transformed a cyclical output recovery process into a productivity-driven economic expansion. Real gross domestic product increased by a cumulative rate of 14.1% in the last two years, even exceeding the historical peak reached in 2000. In our view, productivi-

ty gains are behind such a notable growth performance. For example, labour productivity in the manufacturing sector increased by 11.9% year on year in the fourth quarter of 2003, up from an average of 5.8% in the first three quarters. In other words, output per worker (and per hour of work) increased by a cumulative rate of 35.2% (and 30.7%) in the last three years. Moreover, consolidation efforts in the public sector have reduced employment by 24.7% and boosted productivity by 40.4% since the start of the IMF-supported stabilisation programme in 2000. As a result, the country's overall rate of labour productivity growth has increased from an average of 3.8% in the 1990s to annual rate of 10.3% in the last three years, raising the ceiling of potential growth rate.

Institutional adjustments can keep robust productivity growth on track. Productivity gains initially reflected cyclical trends, as the unemployment rate rose from 5.6% in 2000 to the peak of 12.3% last year. However, the cyclical behaviour has already evolved into a structural trend, in our view, as prudent macroeconomic policies and corporate and public-sector restructuring have resulted in a better allocation of resources. Furthermore, thanks to macroeconomic and political stability for the first time in a long while, the whole economy has started enjoying the full benefits of trade liberalisation in the late 1980s and especially after signing the customs union agreement with the EU in 1995. Although the country's total factor productivity increased from an average of 0.5% in the 1990s to 5.2% in the last two years, macroeconomic stabilisation is not sufficient to keep the current trajectory in place. The Turkish economy needs comprehensive micro-level institutional reforms that would reduce rent-seeking opportunities and the benefits to vested interest from the status quo, promote domestic entrepreneurship, and attract foreign (direct) investments.

Turkey's technological backwardness is a reflection of the *gemeinschaft*. Turkey is experiencing a productivity-driven growth, but companies still lag behind international levels of investment in technology and research and development. The percentage of manufacturing firms making technology-intensive investments remained at 29.4% in the 1998-2000 period, showing a mere increase from 24.6% between 1995 and 1997. However, the renewal ratio is much higher for firms employing more than 250 workers and rising to 60% for companies with more than 1000 workers. In other words, poor institutions do not allow for achieving greater economies of scale and consequently lead to technological sclerosis and unbalanced restructuring in the corporate sector. We believe that a proper institutional framework would not permit outdated, low-productivity organisations to survive longer than they would in an efficient equilibrium and promote the translation of abstract innovations into increased output of goods and services.

Greater economic and political freedom will act as catalysts to enhance growth. The efficiency of microeconomic decisions depends on macroeconomic stability as well as on the existence of an appropriate institutional setting. Therefore, ending the status quo will unlock Turkey's full economic potential, paving the way for a prosperous future in a truly democratic society upholding, above all, the rule of law. Beyond economic benefits, however, we argue that the real significance of institutional metamorphosis is in overcoming the crisis of identity, building the fabric of social trust, and reducing ideological polarisation.

FOCUS ON FUTURES

Analysis and update by Sholom Sanik of Friedberg Mercantile Group

WHEAT

Global wheat crop recovers, but is it enough?

The USDA's first look at the 2004-05 marketing year held few surprises for the wheat market. Global wheat production is expected to rise substantially, to 588.7 million tonnes, up 7% from 2003-04. The bearish impact of this first official forecast on prices was muted, however, because the USDA's estimate was well within the range of estimates we've seen over the past few months, which included estimates from private forecasters, as well as the International Grain Council.

Another item contained in the May supply/demand situation report – also anticipated – was the fact that despite the surge in production, the market is now expected to enter its fifth consecutive year of production/consumption deficits. Consumption for 2004-05 is forecast to increase by 6 million tonnes over 2003-04, or 1%, to 594.15 million tonnes. This will leave ending stocks of 123.26 million tonnes, 20.7% of consumption, the smallest carry-out in modern history. This compares with 128.75 million tonnes, or 21.8%, at the end of the 2003-04 marketing year and 167.07 million tonnes, or 27.8%, for 2002-03. We'd have to go back to the 1972-73 marketing year to find global inventories at such low levels.

The US will retain its status as the world's largest exporter of wheat, but with a much smaller crop than last year. After meeting domestic needs, its sales abroad are expected to fall by 17% from 2003-04, to 26.54 million tonnes. US farmers seeded over 2 million acres less to wheat than last season, resulting in an initial spring- and winter-wheat crop forecast of 56.62 million tonnes, down 11% from last year.

Prices have bounced recently – by as much 30¢-per-bushel – but have now backed off. To some degree, the short-lived strength can be attributed to a piggyback rally related to excessive precipitation that could affect the early planting stage of the corn and soybean crops. But, as the winter-wheat harvest moves into full swing, we find that the wheat crop had weather problems of its own. Drought in many key regions has made even the smaller output estimate seem optimistic. Crop conditions have been slipping. In this week's progress report, the good-to-excellent portion of the crop fell to 41%, compared with 44% the previous week and 53% at this juncture last season.

The health of the US crop is critical to world trade. Crops of three principal exporters of high-quality, milling-grade wheat – Argentina, Australia, and Canada – are expected to be of average size. None of these countries will have enough wheat to increase exports meaningfully.

A good chunk of the increase in global production comes from India (7 million tonnes), which is not likely to export any

substantial amounts of wheat, and the FSU (18 million tonnes), where domestic needs are estimated to have grown and where the USDA estimates that exports will grow by just over 1 million tonnes.

The important improvement among major exporters will be in the EU, which is expected to bounce back to a normal crop size of 126.5 million tonnes after a devastating drought last summer slashed output by 20% from the previous crop year. Its exports are estimated to climb to 14 million tonnes from 9.5 million tonnes last year.

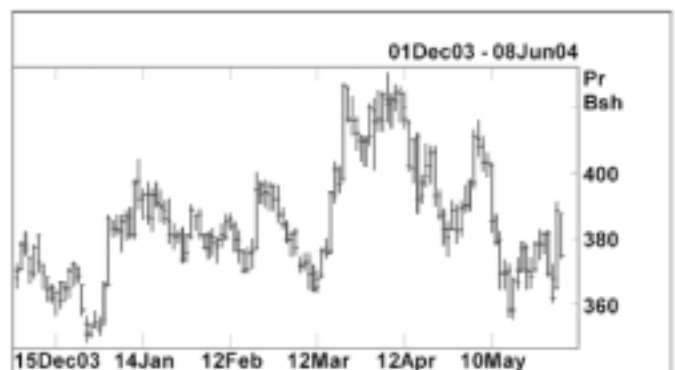
Based on China's buying patterns of both old-crop and new-crop wheat over the past 6 months and the fact that the Chinese wheat crop has been sinking precipitously – 90 million tonnes in 2002-03, 86 million tonnes last year, and a forecast for 84 million tonnes for the new crop – the USDA increased its estimate for Chinese imports by 5 million tonnes over 2003-04, to 8 million tonnes. This represents a return to the mid-1990s when China was a much more significant importer of wheat. With the new marketing year barely a week old, China has already booked 1.6 million tonnes of US wheat purchases for 2004-05 delivery compared with 1.4 million tonnes for all of 2003-04.

To sum it all up, the increase in global production looks impressive in isolation, but many factors have to behave perfectly for the increased supply to actually alleviate the tight global balance. [June 3, 2004]

STRATEGY: Remain long July wheat as per Flash Update of May 20. Maintain stops at 360, close only.

– **Sholom Sanik** (ssanik@friedberg.ca)

Chart 9 – July wheat



Courtesy Reuters

CORN**Larger corn crops do little to alleviate global tightness**

The USDA's first look at the 2004-05 marketing year, contained a major upwards revision to Chinese corn inventories dating as far back as the 1993-94 season. Because China does not publish records of its grain inventories, the USDA updates its own statistics periodically using consumption data that hopefully provide a more accurate picture of stock levels. As a result of the revision, 2003-04 global ending stocks are now estimated at 86.96 million tonnes, a 19-million-tonne, or 28%, increase over the USDA's April estimate. Ending stocks as a percentage of consumption will grow from 10.5% last month to 13.4%.

Demand, however, continues to outpace new supply. The revision, therefore, does not alter the tight global supply/demand situation very much for the new 2004-05 crop year. Higher prices have inspired more planting. Global production will grow by 28 million tonnes, or 4.6%, over 2003-04, to a record 642.58 million tonnes. Consumption is estimated to grow by 13.24 million tonnes, or 2%, also to a record 662.74 million tonnes. While production is expected to grow by more than consumption, demand will still be 20 million tonnes greater than output, causing a further drawdown on global inventories, to 66.8 million tonnes, or 10.07% of consumption, the lowest inventory level in history.

The US remains the only significant exporter in the world, which makes the crop that has just been planted vital to world trade. Until the heavy rains threatened to harm the newly planted crop, things were looking fairly good. As of the May 24 crop progress report, 95% of the crop was planted, compared with the 5-year average of 87%. The excessive rain, however, threatened to harm the more recently planted crops, raising speculation that those fields would have to be replanted or – if they could not be replanted in time – lost to soybeans, which can be planted later.

The first sign of a break in detrimental weather patterns, however, typically erases much of the rally, which is exactly what happened as forecasts for drier weather emerged. Still, it is very early in the season, and the crop is barely in the ground. The USDA is assuming a best case scenario, forecasting record yields of 145 bushels per acre (bpa), compared with last year's yields of 142.2 bpa and 129.3 bpa in 2002-03. Crop conditions are comparable to last year at this time, with the good-to-excellent portion at 68%. However, the most recent progress report showed this is down from the previous week's figure of 71%. Consequently, with the potential of some early damage and a whole summer of unknown weather ahead of us, it is probably somewhat optimistic to believe that record yields are in the bag.

Consumption of corn-based ethanol in the US is on the rise. Usage of corn for ethanol has grown from 25.3 million tonnes in 2002-03 and 30.3 million tonnes in 2003-04 to a forecasted 33 million tonnes in 2004-05. This means that 12.5% of the US crop will be distilled into ethanol, further tightening the availability of supplies for domestic and export uses.

Even with the USDA's rosy outlook for US yields, ending stocks are forecast at dangerously low levels of 18.81 million tonnes, or 7% of consumption. This compares with 7.7% last year and 11.5% in 2002-03. There is not much room to move. If the USDA has either underestimated demand or overestimated the crop, we will quickly slip into a mode that will require much higher prices to ration supply.

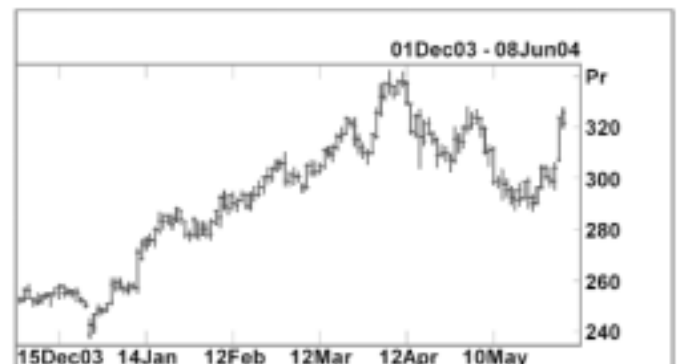
Looking back at 2003-04 to monitor the demand situation, there was some concern that while US export commitments were on pace to meet the USDA's target of 50.8 million tonnes, shipments had slipped a bit. The two most recent reporting periods have shown some improvement, though, with shipments of 875,000 tonnes and 1.149 million tonnes, compared with only 652,000 tonnes a week earlier.

In conclusion, corn prices have seen a fair bit of volatility with commodity funds liquidating a monumental net-long position, creating a down-draft during April and most of May and with the weather related rally then creating a counter-trend move. We believe it's all noise as the market consolidates the \$3-per-bushel level. The market remains extremely tight and we believe will ultimately make new highs. [June 3, 2004]

STRATEGY: *Stay tuned.*

– *Sholom Sanik (ssanik@friedberg.ca)*

Chart 10 – July corn



Courtesy Reuters

SOYBEANS**What happened to the beans?**

July soybeans peaked in early April at \$10.47 per bushel and have now tumbled by close to \$2.50 per bushel since. The recent weakness has been tied to a number of issues regarding the Chinese soy industry. First there were cancellations of Brazilian shipments. Then there was talk that liquidity problems among crushers, sparked by tight credit conditions, would force them to reduce purchasing. Even after separating rumor from fact, it seems fairly clear that the rationing process is progressing. We must bear in mind that this bull market was a result of Chinese imports, and any signal that a significant reduction in imports is afoot should rightfully cause prices to fall.

Unlike corn, wheat, and cotton, the May USDA supply/demand situation report contains new-crop 2004-05 forecasts only for the US. Global new-crop soybean estimates are not released until July. The revisions for 2003-04 were mostly neutral for prices. The USDA confirmed that inclement weather did reduce the crop size in South America. Brazilian output was revised downwards by 2.5 million tonnes from the April estimate, to 53.5 million tonnes. Argentinean production was lowered by 1 million tonnes, to 34 million tonnes. This is quite a drop from the 61- and 36.5-million-tonne estimates we saw as recently as February. Although this resulted in global ending stocks as a percentage of consumption falling to 16% from 16.5%, the report received a yawn from the market. The Brazilian and Argentinean revisions were expected and, in fact, were higher than some of the more extreme estimates.

Traders spent more energy focusing on the new US crop. New-crop prices that have not been seen since the bull market of the late 1980s inspired US farmers to plant 75.4 million acres of soybeans, 2 million more acres than last year. The result would be a record crop of 80.8 million tonnes. This compares with 65.8 million tonnes in 2003-04 and 75.1 million tonnes in 2002-03.

Crop conditions will have to be excellent to achieve this crop size, however, because the USDA's estimate for yields is 40 bushels per acre (bpa), up sharply from last year's 33.4 bpa and slightly higher than the 38 bpa harvested in 2002-03. Such high yields would not be a record, though. In 1994-95 soybean yields were 41.4 bpa.

The USDA does not publish crop condition reports for soybeans this early, because the crop has not been fully planted. The portion that was planted, however, did make it into the ground quite early in historical terms, which is beneficial and makes an optimistic yield forecast more realistic. As of the most recent progress report, 77% of the crop had been planted, compared with 67% last year at this time, and a 72% 5-year average.

The USDA is forecasting total US consumption of 78.9 million tonnes, which would leave ending stocks of 5.18 mil-

lion tonnes, or 6.5% of consumption. This would be a recovery from the modern-day record-low 4.6% stock ratio expected at the finish of the current marketing year. But is it enough of a recovery to end the bull market?

The forecast for consumption may be a bit high. The estimate for US demand includes a 5.18-million-tonne, or 13%, increase in the US crush and a 4.91-million-tonne, or 20%, rise in exports. Most of the meal and oil produced in the US is consumed at home. In 2003-04 meal and oil exports represented 5% and 12% of total consumption respectively, whereas bean exports comprised 36% of usage. The domestic figure is probably more realistic at this time, because crush margins are still running very high and have remained at these levels much longer than most traders believed they would. On the export side, however, we must take the letup in Chinese demand seriously.

Shipments of US soybean exports for 2003-04 stand at 22.9 million tonnes. Exporters must still ship 1.6 million tonnes to meet the USDA target of 24.49 million tonnes. With 14 weeks remaining, shipments will have to average 115,000 tonnes per week. This week's shipments were rather weak at 60,700 tonnes, compared with the average of the previous 4 weeks of 166,000 tonnes.

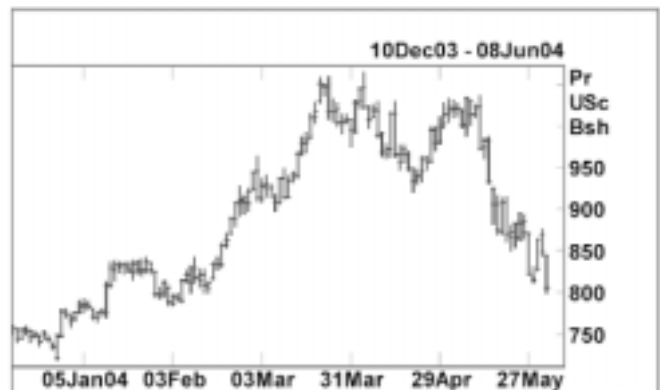
In conclusion, the slide in prices is no mystery. We have now entered weather-market season as evidenced by the wild swings we've seen over the past 10 days. We do believe that actual Chinese needs are not going to disappear overnight. The fact that the South American crop was a bit of a disappointment – although well known by now – is still a bullish factor, particularly if Chinese purchasing resurfaces. We remain neutral at the moment, but do stay tuned.

[June 4, 2004]

STRATEGY: *Stay tuned.*

– *Sholom Sanik* (ssanik@friedberg.ca)

Chart 11 – July soybeans



Courtesy Reuters

SUGAR**Tighter days ahead**

The sugar market hasn't received nearly as much attention as many of the other commodities on the board. For the most part, prices have been contained in a narrow range between 6¢ and 7¢ per pound over the past few months. But prices have increased substantially after threatening the 5¢-per-pound level earlier this year. Are there any bullish fundamentals to support the 30% increase in price, and if so, are they bullish enough to sustain the rally?

As we've pointed out over the past few months, estimates for the 2003-04 global supply/demand balance have moved from a surplus of several million tonnes to a balanced – and according to some analysts, a deficit – market. The most recent revision comes from F.O. Licht. On June 3 it chopped its estimate for global output by 3.3 million tonnes from its March estimate, to 142.9 million tonnes.

The revision was almost all on account of the very disappointing Indian crop. This does not mean that India will need to import any sugar; its inventories are still plentiful. It does mean, however, that although the government has reformed legislation to pave the way for increased exports, it will not actually be exporting any significant quantities of sugar anytime soon.

Licht did not publish revised consumption figures, but using its March estimate of 144 million tonnes, the market has now swung from a 2.2-million-tonne surplus to 1.1-million-tonne deficit. As a result, global ending stocks for 2003-04 as a percentage of consumption would fall to 44.6%, from 46.8%, compared with 48.3% of in 2002-03.

We believe that this contradicts repeated statements by sugar analysts that sugar prices have limited upside. They cite, primarily, the huge 2004-05 crop now being harvested in Brazil. While the crop will indeed be large, two significant issues are emerging.

First, it has been a wet harvest season, which has delayed the harvest. This is not beneficial for yields.

Then, the soaring price of crude oil is almost certain to

increase ethanol consumption in Brazil. The market is expecting the cane crop to be divided evenly between sugar crushing and ethanol. But the market for ethanol has become far more flexible, and usage can become increasingly elastic if crude oil remains anywhere near \$40 per barrel. Flex-fuel cars are becoming very popular and now make up 18% of all new car sales in Brazil. The driver can pull up to a gas station and select the amount of ethanol to add to the tank's petroleum-based gasoline. When the price of petroleum rises faster than the price of ethanol – which has been the case – the consumer's choice is obvious.

Furthermore, Cargill Inc., the agricultural conglomerate, is planning to build a facility in El Salvador that will process Brazilian ethanol for export to the US market. There is a bit of uproar about this, because Cargill is circumventing a 54¢-per-gallon US tariff slapped on any ethanol that enters North America directly from Brazil. US ethanol producers are understandably unhappy with this loophole. Either way, it is clear that there exists a strong incentive to market ethanol.

While the street is expecting Brazilians to split the crop equally between sugar and ethanol, we believe that this is by no means a certainty.

Looking to the global picture for the new crop year, the most recent estimate we've seen comes from the USDA. It forecasts production of 141.5 million tonnes, against consumption of 140.9 million tonnes, for a surplus of 600,000 tonnes. As illustrated, however, we believe that this surplus is tentative and is subject to the completion of the Brazilian harvest and yet unknown demand patterns.

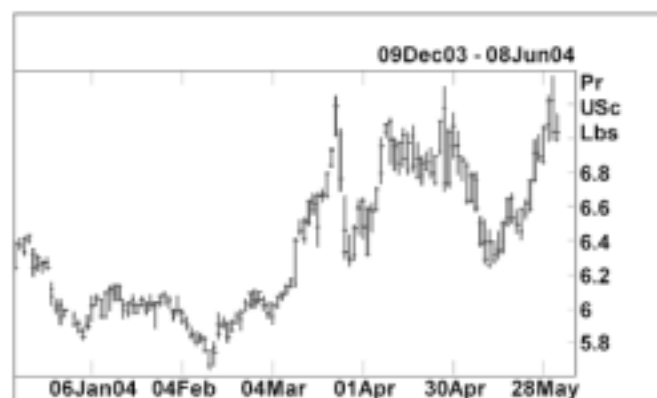
We are definitely bullish and will be looking for an opportunity to jump on the long side of this market.

[June 4, 2004]

STRATEGY: *Stay tuned.*

– *Sholom Sanik* (ssanik@friedberg.ca)

Chart 12 – July sugar



Courtesy Reuters

HOTLINE UPDATE

Friday, May 7, 2004:

Good afternoon for Friday, May 7, 4:25 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On May 4, we covered our short June mini S&P position at 1114. On May 7, we liquidated our long June gold position at 377.80.

We are currently long July corn at 326, with our stop at 301; long July cocoa at 1433, with our stop at 1310; and long July wheat at 388, with our stop at 370. All stops are close only.

Flash Update – Monday, May 10, 2004:

Good morning for Monday, May 10, 11:45 am. This is a Flash Update. We have liquidated our long July corn position at 301,

Flash Update – Wednesday, May 12, 2004:

Good afternoon for Wednesday, May 12, 12:05 pm. This is a Flash Update. We have liquidated our long July wheat position at 370.50.

Friday, May 14, 2004:

Good afternoon for Friday, May 14, 4:30 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On May 10, we liquidated our long July corn position at 301. On May 12, we liquidated our long July wheat position at 370.50. We are currently long July cocoa at 1433, with our stop at 1310. All stops are close only.

Flash Update – Tuesday, May 18, 2004:

Good morning for Tuesday, May 18, 8:35 am. This is a Flash Update. We have liquidated our long July cocoa position at 1310.

Flash Update – Wednesday, May 19, 2004:

Good afternoon for Wednesday, May 19, 4:35 pm. This is a Flash Update. We have purchased December gold at 386, placing our initial stop at 370, close only.

Flash Update – Thursday, May 19, 2004:

Good morning for Thursday, May 20, 10:50 pm. This is a Flash Update. We have purchased July wheat at 372, placing our initial stop at 355, close only.

Friday, May 21, 2004:

Good afternoon for Friday, May 21, 4:50 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On May 18, we liquidated our long July cocoa position at 1310. On May 19, we purchased December gold at 386. On May 20 we purchased July wheat at 372.

We are currently long December gold at 386, with our initial stop at 370; and long July wheat at 372, with our initial stop at 355. All stops are close only.

Friday, May 28, 2004:

Good afternoon for Friday, May 28, 4:45 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 long July wheat at 372, with our stop at 355. All stops are close only.

Friday, June 5, 2004:

Good afternoon for Friday, June 5, 4:15 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 long July wheat at 372, with our stop at 355. All stops are close only.

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