

# FRIEDBERG'S

## FOCUS ON FUTURES

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## Cocoa: the global deficit grows

The cocoa market has been the beneficiary of a fair bit of bullish development, yet prices remain just a chipshot shy of their recent lows.

In early May, peace seemed to be breaking out in the Ivory Coast. Peace talks between warring Ivorian factions were going well, were relayed every morning in the press, and seemed to be providing a backdrop for price erosion. Over the past few weeks, however, violence has erupted once again, and headlines have been replaced with daily body counts. Over the past two seasons, violence had little if any impact on growing a normal-size crop and getting it shipped out of the country. Still, the market will maintain a fear premium, because, after all, 40% of the world's cocoa is shipped out of the Ivory Coast, which is a country at war. Even if farmers can continue to grow their crops unimpeded, only two ports handle all exports. If either is compromised, the cocoa market would experience a supply shock.

Further on the bullish front, Ghana, the world's second-largest producer, was widely expected to grow its second consecutive excellent crop of over 700,000 tonnes. But on June 1 the government announced that it is revising its forecast for 2004-05 output down to 600,000 tonnes.

On June 2, E.D. & F. Man released its latest estimates for the 2004-05 marketing year, which contained some bullish surprises. First, it pegs the global production/consumption deficit at somewhere between 150,000 and 200,000 tonnes, considerably higher than any of the estimates we've seen to date and compared with a *surplus* of 250,000 tonnes in 2003-04. The International Cocoa Association's (ICCO) most recent estimate was looking for a deficit of only 50,000 tonnes. The most significant factor is West African crops, which according to Man will be about 200,000 tonnes smaller than in 2003-04.

Actually, according to our rough estimate, 2004-05 West African production will be closer to 300,000 tonnes below 2003-04 output. The recent Ghanaian estimate mentioned above alone accounts for a drop of more than 100,000 tonnes from the previous season.

The most recent Ivorian port arrival data are running about 11% behind same-time-last-year arrivals, which amounts to a difference of about 150,000 tonnes. So based on the supply side of the balance sheet, we estimate the global

production/consumption deficit to be between 200,000 and 250,000 tonnes.

Turning to the demand side, Man confirms the assumption that we've been making in recent months that grindings are probably stronger than we've been led to believe by US and EU quarterly grind statistics. In fact, Man says that published data omit a good deal of North American and European grindings and that these regions are growing at 5% per annum. Add in origin-country and emerging-market grindings, demand actually grew 3.4% in 2004-05, rather than the zero growth indicated by publicly available figures.

Butter ratios maintain their strength, trading at 2.8 and 2.6 times the London spot price in Europe and Asia respectively.

So why is the market going down?

Commodity funds held an enormous net-long position of close to 45,000 contracts as recently as late-March, but they've been liquidating and turning to the short side. We are quite certain that the \$400-per-tonne fall in price is not commensurate with supply/demand fundamentals, and we continue to believe that a low-risk buying opportunity has emerged. [June 7, 2005]

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Chart 1 – July cocoa



Courtesy Reuters

## **COPPER**

### **Bullish charts, bearish fundamentals**

Market participants who were touting the bearish fundamentals of copper were starting to look pretty smart when prices took a sharp dive to \$1.32 per pound in mid-May. After powering back to new highs and beyond, however, the validity of a solid bearish case must be scrutinized.

The second half of 2004 saw average monthly Chilean output grow by 14% over the same period in 2003. The strength carried into January when production rose 12%, but then the explosive rate of production growth ground to a halt. Over the following three months output declined an average 2.8% over the same period in 2004. So it seemed that there was a shift in the supply side fundamentals.

The slide in output, however, was a result mainly of scheduled maintenance and is expected to be temporary. In addition, new capacity will be coming on line at the Chilean mines Teniente and Chuquicamata.

Despite the recent poor showing by Chilean mines, June International Copper Study Group (ICSG) data show that the process of bringing the global balance sheet back into balance remains on track. Global mine output increased 7.5% in the first quarter over the same period last year, to 3.54 million tonnes, while usage of refined copper fell 5.6%, to 4.03 million tonnes. The global refined surplus stands at 25,000 tonnes, compared with deficits of 364,000 tonnes at this time last year and 755,000 tonnes at the end of 2004.

One issue cited by bulls is the almost nonexistent warehouse stocks, which have dwindled down to multi-decade lows. Combined, the three principal warehouse systems (LME, COMEX, and Shanghai) currently hold 76,000

tonnes of copper. This compares with stocks of over 1.65 million tonnes at the time prices were bottoming in 2002. But analysts have been pointing out that the ICSG lists global refined off-warehouse stocks at close to 900,000 tonnes, and there have not been any reports of shortages by users, even in an anecdotal fashion.

Rather, commodity fund activity has most likely been the primary cause for the volatility and for creating the illusion of a squeeze that may not really exist in the physical market, despite the persistent backwardation that we see in both New York and London. The funds began to liquidate a 35,000-contract net-long position back in March, and the selling pressure eventually broke the back of the market. Now, they've begun to rebuild that long position, which we believe was responsible for pushing the market to new highs. As of this past Friday's Commitment of Traders report, the fund net-long position stands at 23,500 contracts after dipping down to close to 3,000 contracts several weeks ago.

Further evidence exists that the longevity of the bull market in copper is no longer tied to *bona fide* tightness in the physical market and does not represent an insatiable demand for industrial commodities: All the other base metals that trade at the LME – aluminum, lead, nickel, tin, and zinc (see Charts 3 - 7) – made their highs months ago.

As we have stated in previous articles on copper, the global economic outlook may not be bleak, but growth is certainly moderating in all regions. The demand that drove the bull market came from China, and imports have clearly been shrinking. On June 23, customs data out of China showed

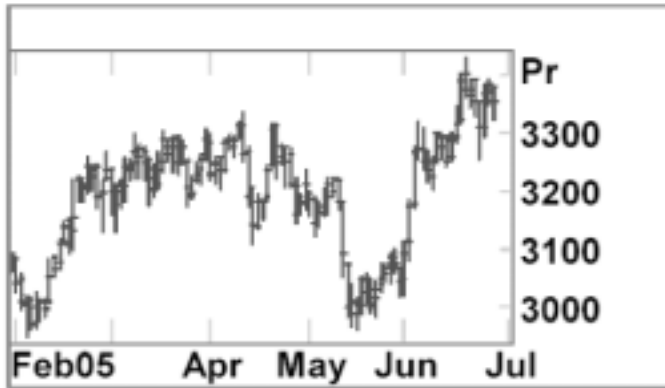
that copper imports in 2005 had dropped 4.1% through the end of May, compared with the same period last year.

Although the chart paints a wonderfully bullish picture, we continue to believe that these prices are not sustainable.

Developing a bearish trading strategy presents a challenge. We advise establishing short positions with protective buy stops tailored to one's pocketbook size and appetite for risk.

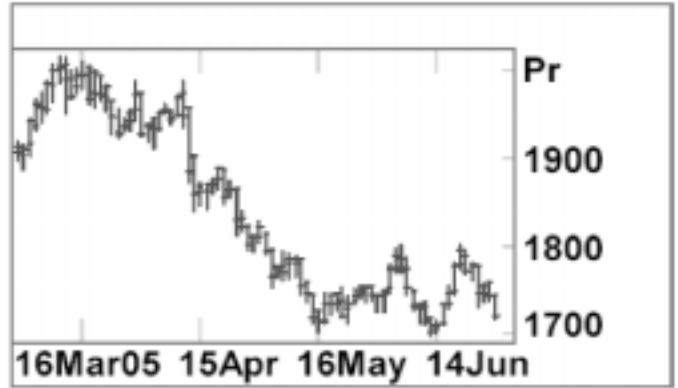
[June 28, 2005]

Chart 2 – LME copper



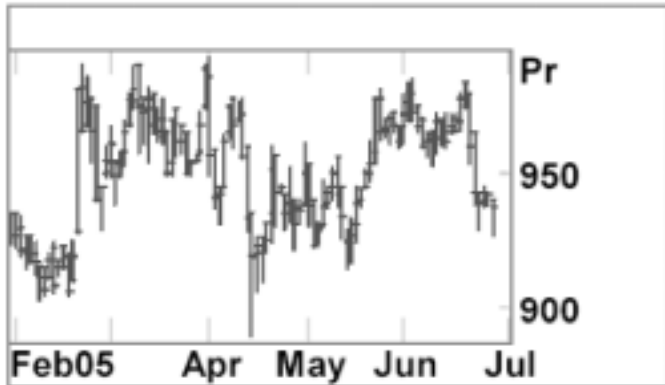
Courtesy Reuters

Chart 3 – LME aluminum



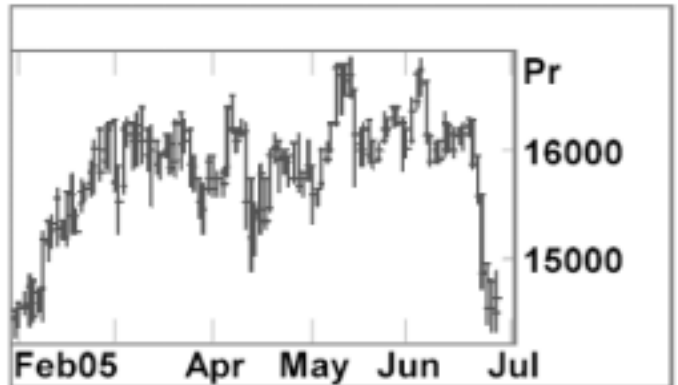
Courtesy Reuters

Chart 4 – LME lead



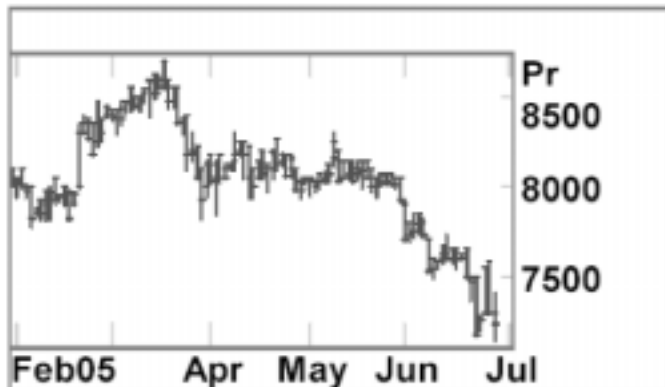
Courtesy Reuters

Chart 5 – LME nickel



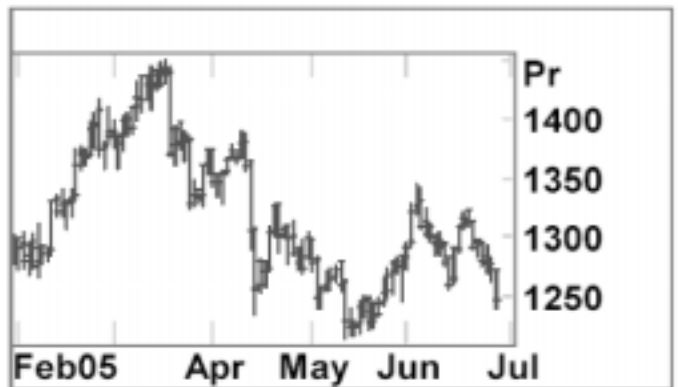
Courtesy Reuters

Chart 6 – LME tin



Courtesy Reuters

Chart 7 – LME zinc



Courtesy Reuters

**WHEAT**

## Hopes for a repeat of last year's bumper global crop are fading fast

Some early growing-season hot and dry weather in the US Midwest sparked a handsome rally in grain and oilseed markets over the past few weeks, but prices suffered a sharp setback after the weather began to improve this past weekend. Wheat prices tagged along for the ride – up and down. But the US wheat crop represents less than 10% of the global wheat supply, compared with 41% for corn and 36% for soybeans. While the effect of volatile US weather may be important for the US balance sheet, it is not as significant a factor in the grand scheme. Besides, as of this past Monday's crop progress report, 48% of the winter wheat crop had already been harvested.

The spring wheat crop, which can still be influenced by weather, is in fairly good shape. This past Monday's report showed 77% of the crop in good-to-excellent condition, down 2 percentage points from the previous week, but still in much better shape than last year at this time when the good-to-excellent portion was 68%.

Still on the domestic side, on June 30 the USDA released quarterly stock and acreage data. The estimate for winter wheat acres was reduced by 205,000 acres from the March estimate, to 41.408 million acres. Spring wheat acreage was lowered by 307,000 acres, to 16.672 million acres. Both were below analysts' guesstimates. After applying the USDA estimate for the harvested-to-planted-acre ratio, this will reduce the estimate for 2005-06 US output by about 18.5 million bushels, or just over 507,000 tonnes.

The inventory report, however, was not friendly to the bull side, with June 1 stocks at 539 million bushels (14.7 million tonnes), compared with guesstimates of 532 million bushels.

On the global front, the June USDA supply/demand situation report forecasts ending stocks at 144.25 million tonnes, or 23.35% of consumption, compared with 24.67% at the end of 2004-05. Although no longer news to the market, there have been a number of developments over the past few months that will lower the USDA's ending-stock estimate significantly.

After deducting for the impact of the US quarterly stock report, the acreage data will still trim global supply by about 300,000 tonnes.

Australia was experiencing drought earlier in the season. The June USDA report lowered its output estimate from its May estimate by 1.5 million tonnes, to 21.5 million tonnes. As recently as June 19, ABARE – the Australian equivalent of the USDA – estimated a measly crop of 16 million tonnes, which brought back uncomfortable memories of the 2002-03 season, when Australia grew just over 10 million tonnes. The weather has been improving, though, and it seems that disaster will be avoided. Still, recent estimates are for output of 20 million tonnes, which reduces the USDA global ending stock tally by a further 1.5 million tonnes.

On June 22, the Canadian wheat board responded to dry weather by lowering the Canadian crop to 22 million tonnes from the USDA estimate of 23.5 million tonnes.

Europe and Asia are having an early, hot summer as well. India is said to become an importer for the first time in six years. The effects of drought in the EU are sure to have an impact as well.

Using only the above developments, we can safely assume that the July global output estimate will be reduced by at least 4 million tonnes. This would draw ending stocks down to about 22.7% of consumption, much closer to the 22.1% of consumption level that sparked a bull run to above \$4 per bushel in early 2004.

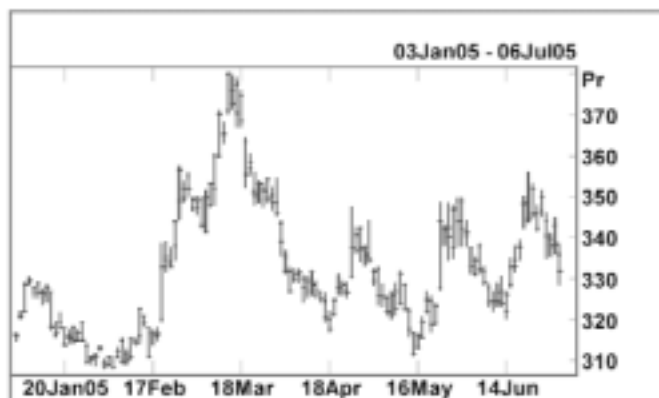
On the demand side, the USDA is forecasting that US exports will continue to slide. The June estimate is calling for annual sales of 25.86 million tonnes, down from 28.85 million tonnes in 2004-05 and 31.56 million tonnes in 2003-04. Early season export commitments are commensurate with the USDA's pessimism. As of this week's report, commitments stand at 5.18 million tonnes, compared with 7.45 million tonnes at this time last year.

As we pointed out in previous articles on wheat, the principal issue is whether the explosive growth in 2004-05 global output was an anomaly or the start of a new trend. Monitoring crop progress of the many significant producing countries is vital. As illustrated, for the moment, it seems that the 624-million-tonne crop farmers grew in 2004-05 was certainly a one-time event.

The chart actually paints a bullish picture with a series of ascending tops and bottoms. At present, the market held the uptrend, and we believe it presents a buying opportunity.

[July 1, 2005]

Chart 8 – September wheat



Courtesy Reuters

**CORN**

**Rain washes out rally**

On June 30, the USDA released quarterly stock and acreage data, and both were bullish for corn prices. The market had other ideas, however, because traders continued to focus on moisture-replenishing weather that was blanketing a parched US Midwest. A week earlier, prices had rallied to levels not seen since August 2004, but that was all being unwound (Chart 9).

Quarterly US stocks as of June 1 were estimated at 4.319 billion bushels, 103 million bushels (2.6 million tonnes) below average trade estimates.

US corn acreage was seen at 81.592 million acres, 179,000 acres above the March 31 estimate, but more significantly, sharply below the average trade estimate of 82.224 million acres.

We're going to assume that the US balance sheet won't look that much different in the upcoming July supply/demand situation report on account of the above revisions, because ethanol usage has been somewhat disappointing. The USDA estimates that consumption grew at just below 20% in 2004-05. With two months left to the marketing year, recent data, however, indicate that this is somewhat optimistic. And for 2005-06, the USDA forecasts that demand will increase by an additional 7% over 2004-05. Still, this is certainly a growth area, and the future is bright for ethanol, particularly with petroleum costs spiraling out of control. Even at the current usage rate, ethanol consumption has grown from 9% of total US corn consumption in 2001-02 to 16% on 2004-05.

With two months left to the 2004-05 marketing year, we are reasonably on track to meet USDA's estimate for US exports. Commitments stand at 43.1 million tonnes and must

reach 45.7 million tonnes. The dip in prices seemed to inspire overseas buyers. The most recent weekly export report showed that US exporters sold 1.2 million tonnes of corn, which was well above the recent average. Shipments are, of course, more important at this point of the season. Exporters have shipped 37.3 million tonnes, or 86.5% of the current commitments, compared with 84% at this time last year.

The next question is yield. Last year's extraordinary performance of 160.4 bushels per acre (bpa) is not expected to be repeated. Even the current estimate of 148 bpa is significantly above the historical norm. The previous high was 142.2 bpa in 2003-04. The most recent crop progress report shows the good-to-excellent portion of the crop at 65%, down 3 percentage points from the previous week and compared with 71% at this time last year. Naturally, traders anticipate that the recent rains improved the outlook for yields.

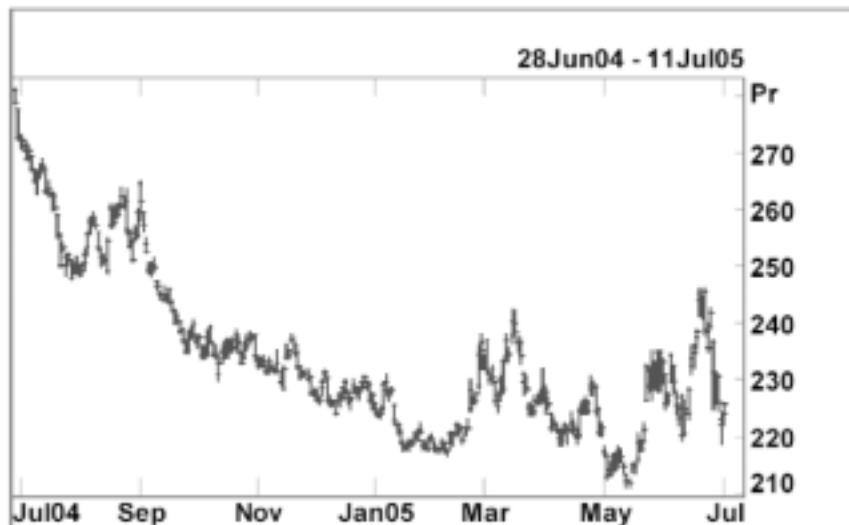
So with the US weather picture less of a factor than it was several weeks ago and being past the two key quarterly reports, there are not many hot issues left on the horizon. Consequently, prices have rightfully retreated to the mid-point of the range in which they have spent most of this year.

The explosive growth in output in 2004-05 did not accomplish very much in terms of rebuilding global inventories. In June, the USDA forecast 2005-06 ending stocks at 121.04 million tonnes, or 17.8% of consumption, compared with 18.9% for 2004-05 and 15.47% in 2003-04.

We therefore believe that this market should be traded from the long side, but with a longer-term perspective, i.e., buying weakness and lightening up on rallies.

*[July 1, 2005]*

Chart 9 – September corn



*Courtesy Reuters*

## **HOTLINE UPDATE**

**Friday, June 3, 2005:**

Good afternoon for Friday, June 3, 5:05 pm. We are currently holding no positions.

**Friday, June 10, 2005:**

Good afternoon for Friday, June 10, 4:55 pm. We are currently holding no positions.

**Friday, June 17, 2005:**

Good afternoon for Friday, June 3, 4:45 pm. We are currently holding no positions.

**Friday, June 24, 2005:**

Good afternoon for Friday, June 10, 4:55 pm. We are currently holding no positions.

**Friday, July 1, 2005:**

Good afternoon for Friday, July 1, 4:30 pm. We are currently holding no positions.

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