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Wheat: are these prices sustainable?

Concern over freeze damage to the US 2007-08 winter wheat crop sparked a rally in April that drove prices to new contract highs (Chart 1) from what had seemed to be a massive breakdown and the end of the bull market. July wheat rose by over \$1 per bushel from the early-April lows and then settled back to the middle of the range.

Indeed, there were regions across the US winter wheat belt that were affected by frost. Temperatures in Kansas – the largest wheat producing state – plunged to the mid-teens Fahrenheit earlier this month. But the most recent industry survey, carried out by the Wheat Quality Council, indicated a huge crop for Kansas of close to 400 million bushels, compared with last year's crop of less than 300 million bushels. Furthermore, it is impossible to say how much damage was sustained, even in areas that dipped below the freezing level, because historically, the winter wheat crop has survived some serious frost and still yielded bumper crops.

In any case, none of the USDA reports issued in the past two weeks have indicated that there are any serious problems with the crop.

On May 11, the USDA issued its first look at the 2007-08 season. The all-winter category, which represents 75% of the total US crop, came in at 1.616 billion bushels, above analysts' guesstimates of 1.59 billion bushels. The information in this report is based on data gathered weeks earlier. More recent reports, however, confirm that the damage was limited. While we won't know much about abandoned acres for some time, the plants that survived are in fine shape. The weekly crop progress report showed that the good-to-excellent portion of the winter wheat crop continues to climb, with this week's report showing another increase, to 59% from 58%, and up sharply from last year's 30% at this point of the season.

US corn and soybean production account for 41% and 37% of world output, respectively. Even with this year's larger crop, the US wheat crop comprises only 9.5% of global wheat output. Other Northern Hemisphere producing regions are expecting large crops in their soon-to-be-harvested winter wheat crops. Large increases will be seen in the EU, FSU, and India.

Australia was very dry in the pre-planting season, and with last year's disaster still fresh in everyone's mind, bulls

are not ignoring this. With planting just getting underway, however, there is ample time for a full recovery to normal crop size.

At 617 million tonnes, it seems that the USDA low-balled its estimate for its 2007-08 global wheat estimate. On April 26, the International Grain Council lowered its estimate, because of potential frost damage to Northern Hemisphere regions, but only by 1 million tonnes, to 623 million tonnes. Some private forecasters were considerably higher.

One bullish factor is the fact that wheat has become very cheap relative to corn in historical terms, which means that depending on the region and availability of corn and other carbohydrate feeds, we can expect demand to remain robust. Chart 2 shows that although the wheat/corn price ratio can be quite volatile, it had been in an uptrend since the beginning of the decade, but has now fallen enough to make wheat commercially viable as feed.

The USDA raised its estimate for 2007-08 global domestic usage just a notch, to 623.87 million tonnes, from 622.18 million tonnes in 2006-07. Our hunch is that this is a very conservative estimate. Expanding populations in Asian countries are likely to increase food consumption, which should include a shift to Western foods and greater wheat consumption. The introduction of fresh dynamics, such as growing usage for feed, can add a lot of luster to the demand side.

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

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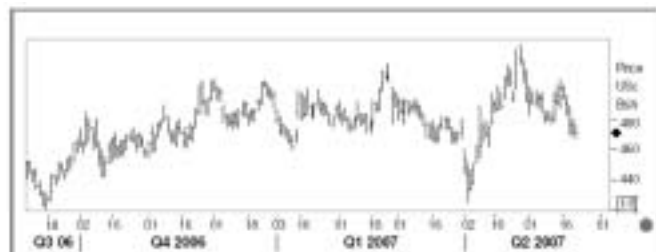
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The cold Northern Hemisphere spring has been the primary influence on prices. As we head into harvest season, the outstanding issue of how much damage was sustained will soon be resolved. Prices are already very high compared with where they've been in the past decade (Chart 3).

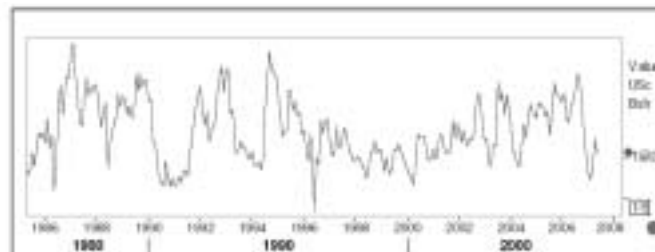
With very small potential for a supply-side surprise at this point, we would need a demand surprise, which, as illustrated, is possible. We find the balance of evidence to be inconclusive, with somewhat of a bearish bias. Remain sidelined, but stay tuned. *[May 29, 2007]*

Chart 1 – July wheat



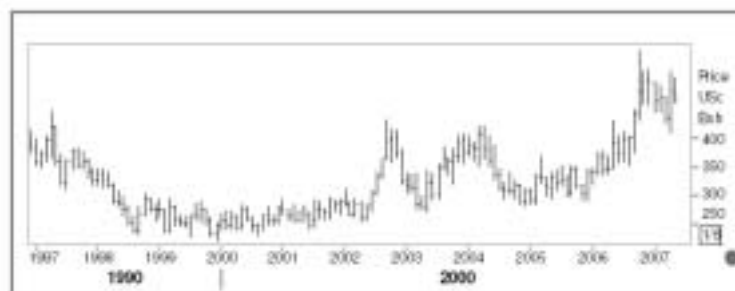
Courtesy Reuters

Chart 2 – Wheat/corn ratio



Courtesy Reuters

Chart 3 – Nearest contract monthly wheat



Courtesy Reuters

COTTON

Is the sharp drop in US acreage enough to tighten the global market?

The initial reaction to the May 11 monthly USDA supply/demand situation report, which presented the first glance of the balance sheets for the new 2007-08 crop, was muted. In the days following the report the market resumed its downtrend and set contract lows. The weakness was a bit of an enigma to us.

The primary bullish factor, of course, is the sharp drop in 2007-08 US cotton acreage, which will be replaced with high-priced and more profitable corn and soybean crops. The March 30 USDA planting intentions report put US cotton acreage at 12.15 million acres, a dramatic slide from 2006-07 acreage of 15.27 million acres. The May 11 report simply reiterated the acreage estimate and used an 820-pound-per-acre yield, just a tad above last year, so it was not even a “buy-the-rumor-sell-the-news” event.

On May 17 Informa Economics released a fresh acreage estimate at 11.9 million acres. Again, the reaction was not

inspiring at first, but the market rallied after traders had a chance to mull over the data. Adjusting the USDA's May 11 data with Informa's revision, output would fall to 18.45 million bales, down from 21.6 million bales in 2006-07. Ending stocks would slide to 6.05 million bales, or 27.6% of consumption. Now, that may not sound like a very bullish number, until you compare it with last year's carryout of 9.5 million bales, or 52% of consumption.

Global output for 2007-08 is expected to compensate to some degree. The Chinese, Indian, and Pakistani crops are just getting in the ground, and all are expected to reach record or near-record levels. The smaller US crop, however, means that the total global production will still be lower than last year's. The USDA's preliminary estimate is 116 million bales, down 1 million bales from 2006-07.

Global consumption, on the other hand, is forecast to grow by 5 million bales, to 127 million bales, which will

result in quite a drawdown of global ending stocks, to 50.71 million bales, or 39% of consumption. This places the global balance sheet in a substantially different position from last year, when ending stocks were 45% of consumption.

Getting back to the US, there is no question that the market could be in a very vulnerable position with the world's largest exporter reducing acreage the way it has. Poor weather would be devastating. In fact, planting progress is slower than normal, with this past week's report showing that only 74% of the crop has been planted, compared with 82% last year at this time and a 5-year average of 79%. Not a great cause for concern, but it does set a negative tone for yields. The US crop cannot afford any glitches.

If there is a bearish angle, it is not on the supply side. With the 2006-07 marketing year drawing to a close, US exports are heading for a disappointing finish. The USDA forecast for final sales currently stands at 13.2 million bales.

Last year, the May estimate for 2006-07 was 16.50 million bales. That estimate was maintained until December, when it became obvious from the pace of weekly export statistics that we would not hit the USDA target. This year's first look at 2007-08 is calling for US exports to reach a record 17.5 million bales.

One cannot therefore help but remember last year's exuberant forecast and wonder whether conditions have changed enough to see US export demand grow to record levels. India has an exportable surplus, and with a healthy crop expected, it is likely to pose formidable competition to the US for the Chinese import market.

In the past the USDA has been spot on in forecasting US export demand, even when the target was seemingly out of reach. This past year was an exception. If the bold projection is borne out, we can see a tight market and higher prices down the road. We advise building a conservative long position in December cotton. [June 1, 2007]

Chart 4 – December cotton



Courtesy Reuters

SUGAR

Just a bear market rally

After plunging to two-year lows in mid-May, July sugar rallied 1¢ per pound (Chart 5). There's been no shift in the supply/demand fundamentals that we know of. There are several bullish developments, but the issues that ended the bull market still prevail. Specifically, just about all significant sugar producing regions continue to grow large crops, despite the fact that the original motivation – soaring prices – has disappeared.

The lone exception is Australia, and that is not for lack of trying. Most Australian crops suffered from drought last year. The sugar crop had the opposite problem – too much rain, as well as disease that destroyed part of the crop. The

harvest came through fairly well, though, considering some of the other disastrous crops. Output reached only 4.9 million tonnes, compared with 5.3 million tonnes in the two previous seasons, but the 2006-07 wheat crop, for example, was 40% the size of the previous season.

This season, analysts have been forecasting a recovery to 5.2 million tonnes based on planted area, but coastal sugar regions are suffering from drought, and it may be premature to forecast a return to normal crop size. Although its crop is small compared with Brazil or India, Australia is an important player because it exports about 80% of its output, and its regular Asian customers would need to turn elsewhere if

there was a shortfall.

India presents a bit of a mixed picture. Output continues to grow. At 27 million tonnes, the current season's crop was a record by far. A May 25 estimate puts the new crop, which will be harvested later this year, at 28 million tonnes.

Domestic prices are falling, and the government is scrambling to get the surplus off the market by beefing up buffer stocks. Earlier this year it created a buffer stock of 2 million tonnes and subsidized the mills that held the inventory by financing the storage costs. The food ministry is currently attempting to pass legislation to increase that buffer stock to 5 million tonnes, which would effectively engineer a pseudo tightness. Still, the massive crop size is obviously bearish. Sooner or later, the sugar finds its way to market.

The 2007-08 Brazilian crop is now being harvested, and the numbers are overwhelming as well, but like India, not all of the bountiful crop will find its way to the sugar market. Cane production for 2007-08 is forecast to rise by 10%. Sugar output is expected to grow to 31.3 million tonnes, up from 30.2 million tonnes in 2006-07, a 3.6% increase. A much larger share of the cane crop, however, will be turned into ethanol. Ethanol output is expected to grow to 20 billion liters, a 14% increase over 2006-07. The ratio of ethanol to food will expand to about 53%, compared with about 50% last year.

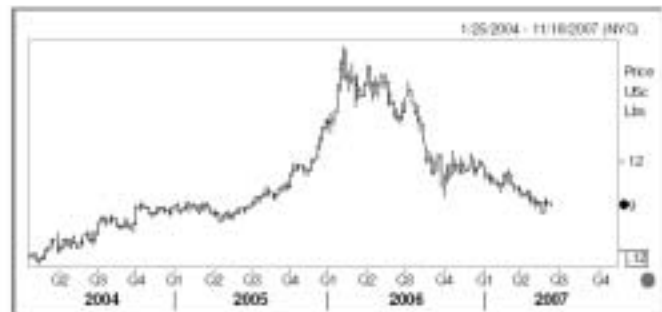
Brazilian ethanol demand is in a perpetual uptrend for both domestic usage and the export market. The minimum ethanol requirement is set to rise back to 25% from 22%, and exports are forecast to grow by 15% in 2007-08. Flex-fuel cars, which allow consumers to control the ratio of ethanol and petroleum they put in their vehicles, comprise 84% of all new-car sales in Brazil.

Despite the growth of the ethanol market, producing nations have increased output enough for all of the major sugar statisticians to agree that we are looking at another marketing year that will close with an 8- to 10-million-tonne sugar surplus. As illustrated, there are a few weak spots in the bearish case, but we can see these factors manifesting only if there were a supply surprise generated by poor weather. Other than that we view the current strength in prices in the context of a short-covering rally by commodity funds.

Analyzing the open interest in sugar has become rather confusing, because it does nothing but grow (Chart 6). Still, the pattern of activity indicated by the Commitment of Traders report shows that commodity funds are tiring of the short side and are covering their shorts. They still carry a substantial net-short position of 35,000 contracts, so we could see further buying in the short term. But we remain bearish for the long haul and advise adding to short positions on strength.

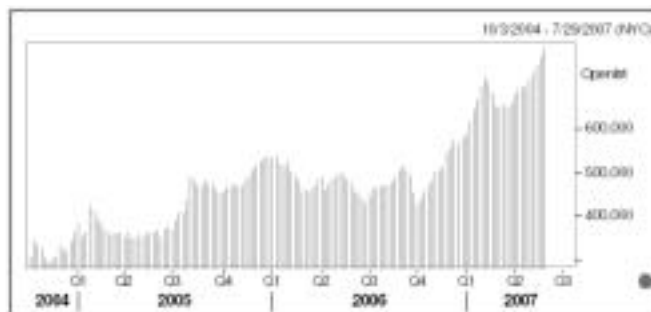
[June 4, 2007]

Chart 5 – Nearest contract sugar



Courtesy Reuters

Chart 6 – Open interest



Courtesy Reuters

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Subscription Enquiries for
Friedberg's Focus on Futures
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 Ltd.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada M5J 2T3
1-800-461-2700

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