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FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 11, No. 5 June 13, 2008

Cotton: shrinking US acreage, growing global demand

The May USDA supply/demand situation report contained several revisions to the US 2007-08 old-crop balance sheet.

On the supply side, the long-harvested crop was revised downwards by 190,000 bales.

Combined commitments for US exports in the last two weeks of April were 1.2 million bales, which certainly compensated for some previous sluggishness. Although commitments are still in a position to meet the forecast for annual sales of 14.5 million bales, the USDA cut the estimate by 300,000 bales, because shipments are running behind the pace that would be required to meet the target by July 31, the end of the marketing year.

Rounding out the revisions, domestic usage was reduced by 100,000 bales. As a result of these changes, US ending stocks were revised upwards, by 200,000 bales, to 9.9 million bales. Most everything else about the report, however, was bullish.

The estimate for the US 2008-09 crop was based on the March 31 planting intentions report, so there was nothing new there. But because of poor weather, planting is behind both last year's pace and the historical norm. As of the most recent crop progress report, 36% of the crop has been planted, compared with 41% last year and the five-year average of 44%. As a result, the early estimate for yield was 830 pounds per acre, compared with 870 pounds in 2007-08.

Moreover, the estimate for acres to be harvested as a percentage of those planted fell back to the 10-year average of 89%, down sharply from last year's exceptional 97%. This puts the crop forecast at 14.5 million bales, down from last year's 19.21 million bales and 2006-07 output of 21.59 million bales. US ending stocks as a percentage of consumption will plunge to 5.6 million bales, or 29.8% of consumption, down from 52.7% last year.

With more than half the acres still not planted and with soybean and corn prices still way up in the stratosphere, it is reasonable to assume that at least some cotton acres will be switched – where the choice exists. We'll get a better idea

with the release of the June 30 acreage report.

Foreign producers are not picking up the slack. Total 2008-09 non-US output is estimated at 103.5 million bales, up from 101.26 last year. The increase is insufficient in light of an anticipated 5-million-bale jump in global consumption and close to 5-million-bale drop in US output. With profitability of planting most other commodities – which are trading at or near record highs – greater than that of cotton, we are unlikely to see a recovery in cotton output this season.

Global ending stocks will fall to 55.55 million bales, or 43.7% of consumption, compared with 49.4% in 2007-08. This may not seem very dramatic. The bull market in 1994 that drove prices to \$1.15 per pound saw global inventories fall to a low of 32.5% of consumption.

The size of the global stockpile is deceptive, though, because Chinese ending stocks account for roughly a third of global inventories, but Chinese imports continue to grow. The USDA updated the Chinese database in this month's report to include an additional 3.1 million bales of stock for the period between 2002-03 and 2007-08. This does not mean that there is more cotton available, only that we were counting incorrectly.

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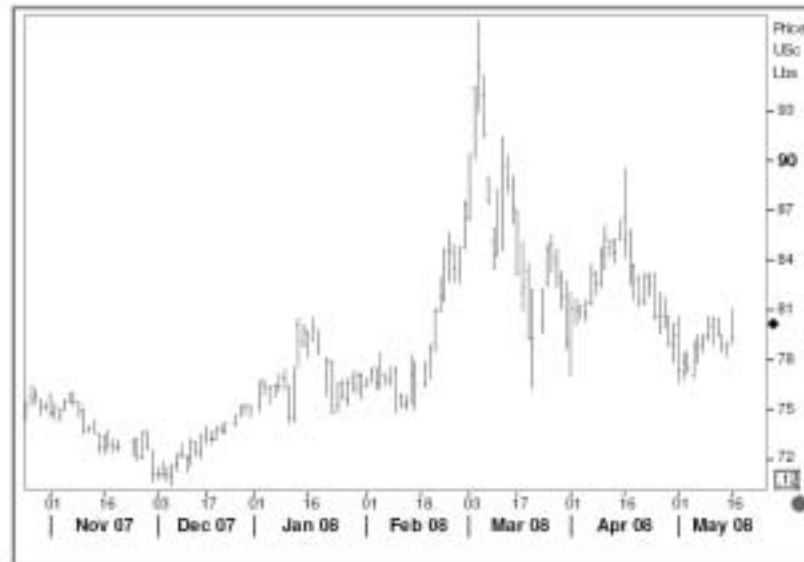
If in fact 2007-08 Chinese inventories were mobile, ready to be used, and of milling quality for export to Western countries, Chinese imports wouldn't be as strong as they are. Thus far this season, China has committed to buy 4.150 million bales from the US, compared with 4.25 million bales all of last marketing year. US exporters have shipped 67% of year-to-

date commitments, compared with 53% at this time last year.

We still don't know the extent of the sharp drop in global supplies stemming from the smaller US crop. Even a 14.5-million-bale US crop is a throwback to the 1980s, when global demand was 30% less than it is now.

Remain long December cotton. *[May 16, 2008]*

Chart 1 – December cotton



Courtesy Reuters

COPPER

Tilting to the bear side

Chart 2 shows that on May 5, July copper spiked to \$4.26 per pound. That was up 42¢ from the previous night's settlement and a fresh all-time high. On the chart, the spike looks like a faulty tick – and for all intents and purposes, it may as well have been. The rally was triggered by news that Codelco's Teniente mine in Chile was to remain idle while a subcontractor strike continued. Once the market had its way with the shorts, prices fell right back and closed a "mere" 12¢ up on the day. The entire possibly-largest-ever one-day move in the copper market lasted for moments only. Prices, which had been hovering near their highs for months without making any progress, proceeded to slip into a downtrend from which they have yet to recover.

The market is rife with mixed signals. On the bullish side, near-term market reaction to labor strife is almost always exaggerated – as illustrated above. Nevertheless, Chilean production continues to be a disappointment relative to built-up expectations that grew from capacity expansion.

Average monthly mine output so far this year has been down 1.85%. Mine production in other important copper mining regions, such as Indonesia, has continued to grow, but the gains pale in comparison with falling output in Chile.

Global inventories – at least in terms of warehouse stocks – remain depressed (Chart 3). Combined stocks at LME, COMEX, and Shanghai are about 30% below year-ago levels.

According to the International Copper Study Group's most recent monthly summary, the 2008 global balance sheet is once again building a deficit, albeit a small one for the moment. Overall, global production and consumption are both flat when compared with activity at this time last year.

The potential for a bearish demand side is obviously hanging over the market. US industrial production for April was down 0.7%, the largest monthly drop since September 2005, which incidentally was considerably worse than the 0.3% the street was expecting.

The most recent EU figures are for March, which showed industrial production fell by 0.2%. But many of the member countries have reported some hefty downturns for April, so we can expect a much larger drop for the EU when the May figures are released in mid-June.

The always-reliable bullish argument for any and all commodities – China – has also shown some signs of strain. While Chinese demand for refined copper is estimated to grow by 9% in 2008, imports have fallen back, as domestic inventories are being drawn down. Imports of refined copper in April were 1% higher than March, but 31% lower than last April. Based on customs data, imports for May and June are expected to fall further.

Backwardation at COMEX is all but gone (Chart 4), but at the LME it has widened considerably during May (Chart 5).

If the production issues were resolved and growth of Chilean output became consistent, the near certainty of softening demand in industrialized countries would render this market dramatically overpriced. The remaining bullish factor would be the indiscriminate bull market in commodities in which supply/demand factors are not a primary factor.

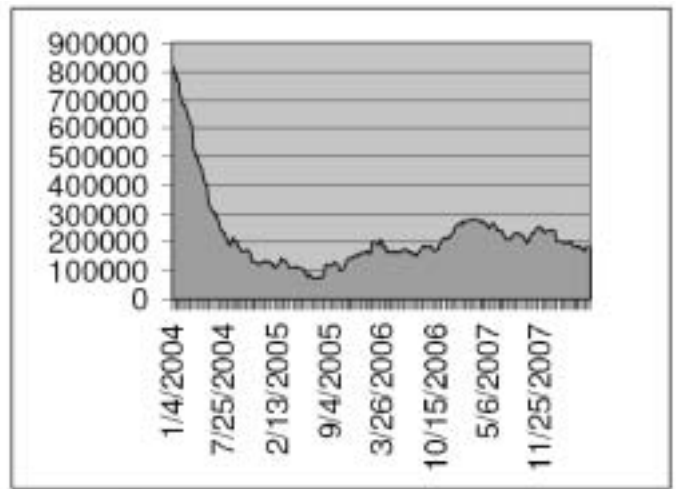
Maintaining our July/December bear-spread position on COMEX has proved to be a boring, but winning, strategy. As July heads into delivery, we recommend rolling the spread forward to September/March. [June 5, 2008]

Chart 2 – July copper



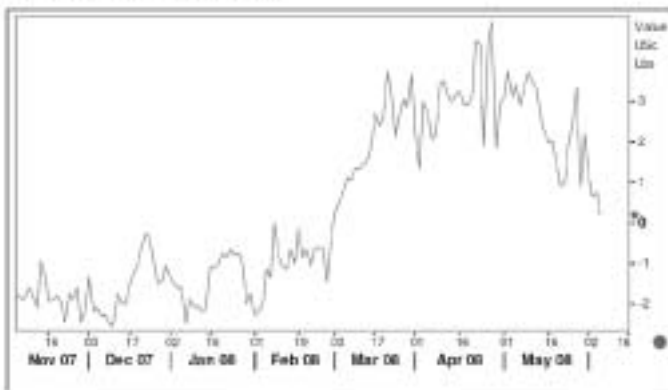
Courtesy Reuters

Chart 3 – Global warehouse stocks



Courtesy Reuters

Chart 4 – Comex cash/3-month spread



Courtesy Reuters

Chart 5 – LME cash/3-month spread



Courtesy Reuters

WHEAT**Trouble brewing down under**

After a precipitous slide that began in early March and a month-long consolidation, wheat prices have begun to stir.

The June 10 USDA supply/demand situation report was actually rather bearish. The May estimate for record global output was revised upwards by 7 million tonnes. The estimate for consumption was increased as well, but only by 4 million tonnes. In addition, ending stocks for the outgoing 2007-08 marketing year were revised up by 5 million tonnes. The combination allowed the estimate for global ending stocks for 2008-09 to be increased by 8 million tonnes over the May estimate, to 132 million tonnes, or 20.4% of consumption, compared with 19.3% for the May estimate, and 18.5% at the end of 2007-08. The rare surplus should allow the rebuilding of depleted world inventories to begin. Maybe.

The report may have been bearish, but a closer read of the report and an update on recent developments show clearly that there is precious little that is bearish about this market.

First, the impact of the hike in the forecast for output is minimal in terms of world trade. The largest revision was a 5-million-tonne increase in the estimate for Chinese output. Aside from the fact that it was widely expected, China has not been an importer at all or significant exporter for years now. Larger-than-expected crops in the US and FSU will add 4 million tonnes of wheat that will be available for export, but are highly likely to be mitigated by the following factors:

Corn prices have literally exploded because of disappointment with the US crop (more on corn in the following article). This means that feed demand will spill over in a large way to other carbohydrate markets, mainly wheat.

Then, over the past 10 days or so, the market has grappled with weather problems in the world's (traditionally) second largest exporter (actually it's normally a three-way tie between Australia, Canada, and the EU). In the 2005-06 marketing year, Australia shipped 16 million tonnes of wheat abroad. Then, for the following two drought-stricken seasons, exports dropped to 8.7 and 7.5 million tonnes, respectively. The Australian situation was one of the factors that contributed to wheat prices soaring to close to \$13.50 per bushel.

There are several wheat growing regions in Australia, and most of them have been planted with reasonable expectations for a return to normal climatic conditions for the growing season. Roughly 30% of the country's wheat acres are in the eastern part of the country, and these areas have seen a return of dry conditions, which has delayed planting because of a lack of sub-soil moisture. The market has been seesawing between forecasts. During May, there were

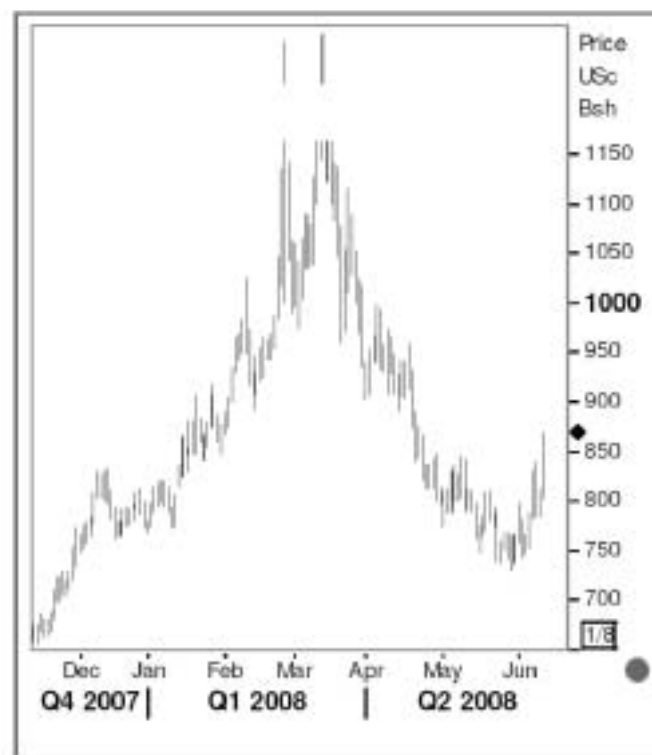
moments when the situation looked fairly bleak, but there has been some rain. Not enough, though. There is a four-week window from here on in for the crop to get planted. Optimum yield potential, however, diminishes with each passing day.

Some private forecasters have been talking about a 27-million-tonne crop. We're quite confident that anything close to that is near impossible. Most analysts are talking cautiously about the inevitability of lower forecasts. The USDA did not lower its 24-million-tonne estimate in its June crop report, but then again its estimate was already the most conservative of the lot. A worst-case scenario, which would include poor yields and not planting all intended acres, would represent a loss of about 5 million tonnes. It might be a bit of a stretch to expect such deep production losses, but there are some analysts who slashed their estimates for Australia by several million tonnes.

While it's premature to predict a disaster, the vulnerability of the market is underscored when one region gets into trouble, and it threatens upheaval for the global market.

Remain long wheat, any variety. *[June 12, 2008]*

Chart 6 – July wheat



Courtesy Reuters

CORN

Somebody forgot to plant corn!

If this is the golden age of unbelievable feats for commodity markets, corn is one of the leading stars. Prices shot right past the previous highs several sessions prior to the release of the June 10 USDA monthly crop report (Chart 7) in anticipation of significant revisions to May estimates for the US 2008-09 crop. After seeing the figures in black and white, traders topped off the rally, taking December new-crop corn to the \$7-per-bushel level and beyond.

It's still a bit difficult to comprehend how all this happened. Back in the spring of 2007, US farmers responded to the burgeoning ethanol market by planting a record-by-far 93.6 million corn acres. For all of 2007 and right into the 2008-09 planting-planning season, soybean prices were outperforming corn (Chart 8), causing a shift of millions of acres to soybeans that otherwise would have been planted to corn. The March 31 planting intentions report surprised everyone with even a larger switch than analysts had expected. US farmers were to plant only 86 million acres of corn for the 2008-09 crop.

Ethanol started getting a bad rap both in terms of belief that the USDA had overstated demand as well as from loud complaints of how the growth of ethanol demand was becoming a significant cause of food price inflation by stealing billions of bushels of corn from the food side of the balance sheet. However, with crude oil trading at over \$135, it is rather unlikely that demand for subsidized and cheaper ethanol will wane. While it is quite accurate that sharing the US corn crop between feed, food, and fuel has increased the cost of everything in the corn chain, it has not eased the use of ethanol – and is not likely to.

Indeed, the idea that the ethanol story had been overblown kept us lukewarm to the bullish cash for a long time, and we missed a huge chunk of this roaring bull market.

In a typical season, the US grows close to half the world's corn and accounts for more than half of world trade. In an era of skyrocketing growth in demand for both food and fuel, its relatively modest acreage has left the US farmer extremely vulnerable to adverse weather conditions for both the planting and growing periods. Mr. Murphy has already paid a visit. The wet weather has hampered planting activity to such an extent that it was a foregone conclusion that the

USDA would eventually have to lower both the planted-acre estimate and the yield estimates, which is why the market rallied heading into the June 10 report.

Weather conditions had changed the outlook dramatically enough that talk among analysts had it that the USDA would make the rare move of altering its acreage and yield estimates in the June report. Acreage was left at the March 31 figure, but the average yield estimate was lowered by 5 bushels per acre, which brought the crop down by 390 million bushels, to 11.735 billion bushels, or 298 million tonnes.

It is obvious that acreage will also be revised downwards, particularly after the recent spate of devastating floods in the Midwest.

US ending stocks for 2008-09 are estimated at 17.08 million tonnes, or 5.4% of consumption. It is not the lowest on record, statistically speaking, but it will become the lowest on record after we find out how many acres were lost and get a more accurate idea of the size of the crop.

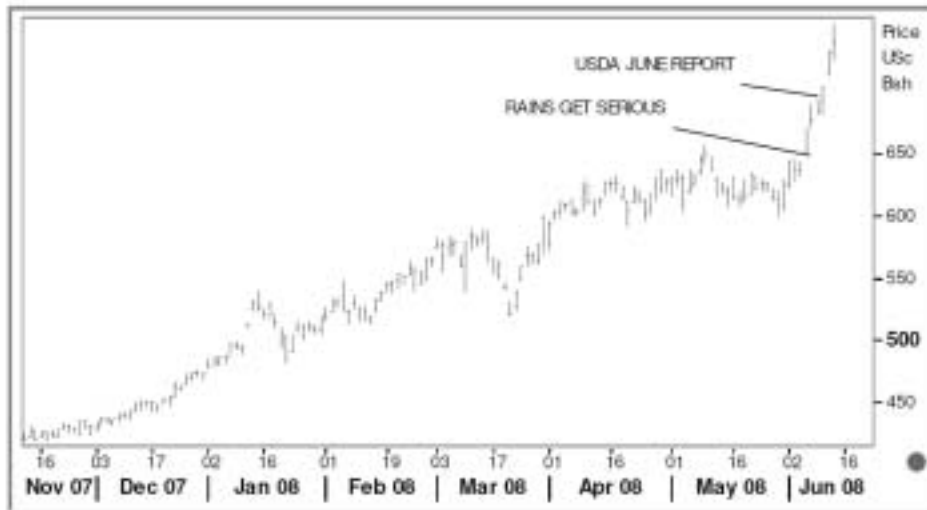
Furthermore, the USDA is estimating lower usage for the domestic feed and export sectors. Livestock feed purchases have been declining because of the significantly higher costs, but there has been no indication that overseas demand has slackened. For the 2007-08 marketing year, the US has export commitments of 59.1 million tonnes and has shipped 48 million tonnes. The target was lowered by 1.25 million tonnes from the May estimate, to 62.23 million tonnes, still a record for US exports. With prices where they are, it is understandable that there would be somewhat of a slowdown. But shipments have been moving at a steady clip of about 1 million tonnes per week over the past three weeks, and with ample time until the end of the marketing year on Aug. 31, the target should be met.

This is a very serious situation. With the planting season for corn all but over, the supply side cannot be vindicated. We're on the brink of unprecedented heights.....well, we've done that already! Prices need to go significantly higher to ensure that South America gets into the corn business in a much larger way and that next year's US acreage is maximized.

Remain long.

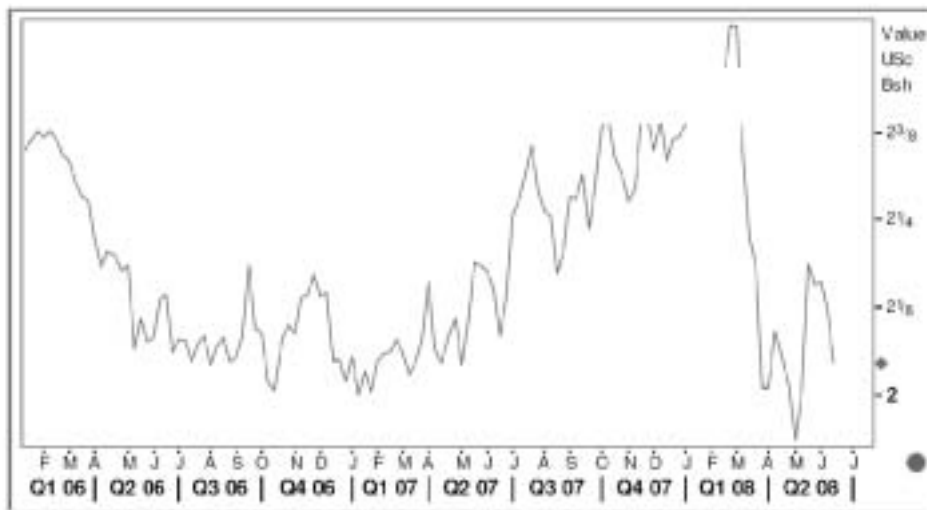
[June 13, 2008]

Chart 7 –December corn



Courtesy Reuters

Chart 8 – New crop beans/new crop corn ratio



Courtesy Reuters

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