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Wheat: Russia lifts export ban

Last summer, the worst drought in many decades slashed FSU wheat output. Major exporters Russia, the Ukraine, and Kazakhstan saw 2010-11 production fall from the previous season by 33%, 43%, and 19% respectively. Exports for 2010-11 fell from 37 million tonnes, or 27% of world trade, in 2009-10, to 13 million tonnes, or 10.5% of world trade. Russian exports, normally the largest of the group by far, tumbled to 4 million tonnes, down from 18.56 million tonnes in 2010-11.

In response, the Russian government instituted an export ban to avoid domestic shortages and to keep prices from spiraling out of control. On May 30, with an anticipated recovery in grain crops, the government announced that the export ban would be lifted as of July 1.

The market reacted swiftly, shedding as much as 50¢ per bushel over the next few sessions (Chart 1). Will Russian wheat exports now flood the market and mark the end of the bull market?

There is no question as to whether this development was bearish – clearly, it was. The degree of bearishness, however, may have been overstated. There was never really any doubt that the Russians would allow wheat exports. The total lifting of the ban, however, was something of a surprise to the market, and that was what the market reacted to.

Early press releases were ambiguous regarding the amount of wheat that was involved. The estimates for total Russian 2011-12 exports that we've seen range between 13 million tonnes and 15 million tonnes. That compares with the USDA's estimate of 10 million tonnes contained in the May crop report. So the additional amount of wheat that would otherwise have become part of Russian ending stocks was 3 million to 5 million tonnes.

There are several reasons why the end of the ban might have only a limited impact on world trade. First, the wheat that the Russians are going to sell abroad is generally of lower quality and does not address the problem of low global inventories of food-quality milling wheat. The highest quality wheat in the US is hard red spring wheat, traded at the Minneapolis Grain Exchange. Chart 2 shows that since the European drought began to develop last summer, the spread between Chicago Board of Trade wheat – which represents a broad basket of deliverable grades – and Minneapolis wheat has gone from flat to over $2.40 per bushel! So while a few million tonnes of Russian wheat will alleviate tightness in one sector of the market, it will do little for the void left by last year's drought and the subpar Australian crop.

Second, the Ukrainians replaced their wheat export quotas with an export tax, which effectively means that there are still export restrictions for the broader FSU market.

Furthermore, winter wheat weather in the US, France, and Germany has stressed crops in many regions, which leaves the strong possibility that output estimates will be revised downwards in the June 9 USDA crop report in these key producing nations.

The USDA presented its first look at the 2011-12 marketing year in the May 11 crop report. Ending stocks are forecast at 181 million tonnes, or 27% of usage. That compares with 30% and 27.5% for 2009-10 and 2010-11, respectively. While global inventory levels are set to fall again, they are still above the mid-decade lows that triggered the bull market (Chart 3). Nevertheless, we have dipped back into vulnerable territory in which any single-country crop crisis would be enough to create tightness, and, indeed, draw inventory down to dangerous levels. Moreover, USDA estimates lump all grades of wheat

Inside

Cotton: Impact of expected dismal US crop 3

Soybeans: Wandering aimlessly 4

Cocoa: Supply overstated? 5

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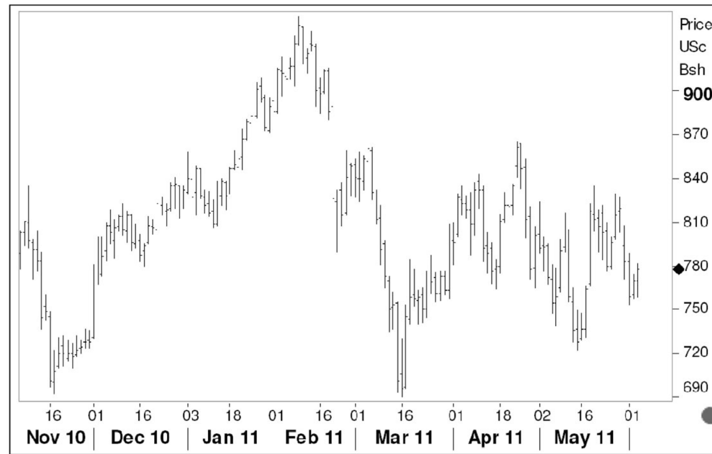
together and do not tell the whole story regarding the drop in the ratio of milling quality wheat to lower quality grades.

Remain long Chicago Board of Trade and Kansas City Board of Trade wheat. Place sell stops, basis July, at $7.20 and $8.40 per bushel, respectively. *[June 3, 2011]*

Chart 1 – July CBOT wheat

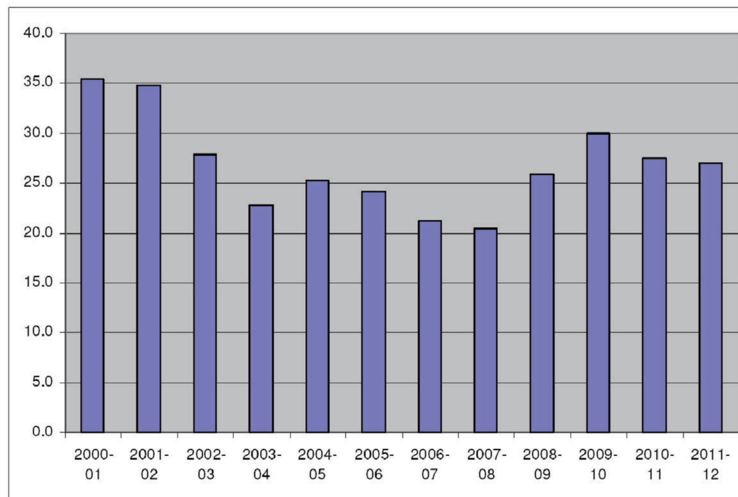


Courtesy Reuters

Chart 2 – July CBOT/July Minneapolis spread

Courtesy Reuters

Chart 3 – Global wheat ending stocks as percentage of consumption



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COTTON

Is a US crop failure enough to keep the cotton bull chugging?

Old- and new-crop cotton prices have converged. At its widest, the July/December spread reached an unprecedented 90¢ per pound, but has recently traded as low as 14.5¢ per pound (Chart 4).

Global output in the 2010-11 marketing year jumped by 13% over the previous year. Spot prices skyrocketed to record heights regardless, because seemingly insatiable Asian demand sopped up all exportable surpluses, leaving exporting nations with very low inventories. New-crop prices remained depressed, because it was assumed that high prices would ensure that farmers in all producing nations would ramp up production once again in 2011-12 to alleviate the tightness. A lethal combination of users scrambling for supplies and selling pressure on new-crop contract months was strong enough to form the truly classic backwardation we witnessed.

By early March, however, importing nations began to cancel some old-crop commitments, and spot prices plunged. The cancellations made for bearish headlines, but the actual number of cancellations was not that significant. Net old-crop cancellations for US exports from March 10 to date totaled 212,000 bales, which is merely a slow week's sales. To account for the cancellations, the June 10 USDA crop report lowered its projection for 2010-11 shipments, from 15.50 million bales in May, to 15 million bales. With nine weeks left to the marketing year, US shipments will have to average about 250,000 bales per week to meet the target, which is not an insurmountable obstacle.

At 5.3 million bales, new crop sales are still well above average for this time of year. Last year at this time, new-crop sales were only 1.6 million bales. But since mid-April, new-crop sales have slowed to a seasonal pace. As a result, the USDA revised 2011-12 exports downwards as well, from 13.5 million bales, to 13 million bales.

New-crop prices have not fallen apart, though, because US weather conditions are turning into a real disaster. The 1.5 million additional acres planted for the 2011-12 crop are all for naught. In the June crop report, the USDA lowered the harvested-to-planted ratio to 81.1%, down from the 86% May estimate. This compares with a 2010-11 ratio of 97.5%! The estimate for the 2011-12 crop now stands at 17 million bales, more than 1 million bales below last year's crop.

On June 13 the USDA released its first crop condition report for cotton. The good-to-excellent portion of the crop was a scant 28%. That is dramatically worse than last year at this time when the top portion of the crop comprised 62% of the total. All principal growing regions in the US – Texas, the Mississippi Delta, the Southeast, and California – remain dry and in need of rain.

Global ending stocks for 2011-12 are forecast to rise to 40% of consumption, up from 36.5% in 2010-11. China, India, and Pakistan are all expected to have much larger crops, which means that at the moment we are not looking at slipping back into a tight spot market. Still, Chart 5 shows how weak global ending-stock levels remain relative to the years of burdensome inventories.

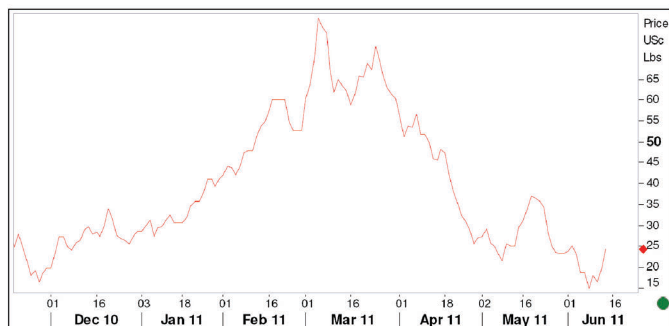
In the immediate future December cotton will be priced off the fortunes of the US crop. The USDA slashed its estimate for 2011-12 US exports because of expectations that larger crops in other producer/exporter nations will compensate for what looks to be a dismal US crop.

Chinese acreage expanded by 6.5% over 2010-11. Weather has not been perfect, but good enough to anticipate that the USDA's 33-million-bale estimate – up from 30.5 million bales last year – could be achieved.

Another bearish factor, which has been difficult to quantify, but from anecdotal evidence and simple logic seems to be credible, is that synthetics have made inroads because of the prohibitive price of using cotton in lower-priced, mass produced clothing.

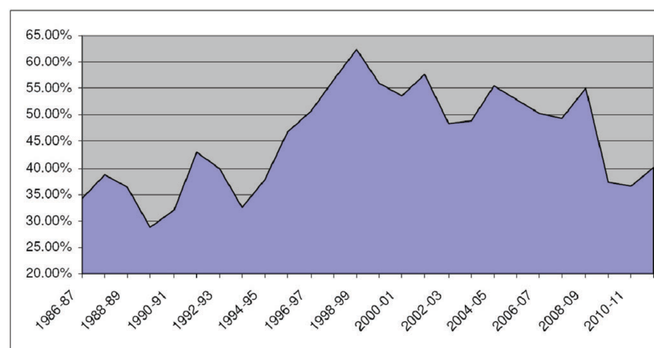
Protect long positions in December cotton. Raise stops on December cotton, which we recommended on April 15, from $1.10 per pound, to the recent lows of $1.28 per pound, close only. *[June 15, 2011]*

Chart 4 – July/December cotton spread



Courtesy Reuters

Chart 5 – Global cotton ending stocks as a percentage of consumption



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SOYBEANS

Wandering aimlessly

The June USDA supply/demand situation report maintained its May output estimates for the 2011-12 US soybean crop for both acreage and yield. Normally, that's par for the course between the March 31 and June 30 acreage estimates, at least as far as acreage is concerned. This year was different, though, because massive flooding forced the USDA to lower corn acreage by a not insignificant 1.5 million acres, or 1.6%.

There was some expectation that some of the abandoned corn acreage would be planted to soybeans. The window for corn planting closes earlier than for soybeans, which gives the land more of a chance to dry from the excessive precipitation. While the USDA left the soybean area estimate unchanged, private forecasters still believe that soybean acreage estimates will be revised up in the June 30 acreage report.

The May estimate for US 2011-12 ending stocks was 160 million bushels (4.4 million tonnes), or 4.8% of usage. That was a bit scary, because it would have been the fifth consecutive season of record- or near-record-low carryover stocks. However, the demand side weakened between reports, and as a result of a combined 30-million-bushel (817,000 tonnes) downward revision in old- and new-crop export estimates, the forecast for 2011-12 ending stocks rose to 5.8% of consumption. That's still tight by historical standards, but provides some breathing room.

Old-crop export commitments stand at 41.8 million tonnes, which is actually above the USDA estimate for a downwardly revised 41.37 million tonnes. Even that revised estimate is likely to be lowered again. Weekly shipments would have to average about 400,000 tonnes per week to meet the USDA target, but they've tailed off sharply, averaging below 200,000 tonnes over the past four weeks.

Of course, it's no great surprise that foreign demand for US beans would begin to wane at this time of year. South American crops are in harvest, and the Chinese have shifted their buying interest to Brazil and Argentina.

The Brazilian crop had its weather challenges this year, but yields were excellent, regardless. The USDA revised its output estimate to 74.5 million tonnes, up 1.5 million tonnes from the May estimate.

The soybean market participated in the recovery in commodity prices that followed the 2008 commodity-price collapse (Chart 6). Prices doubled. It is questionable whether the powerful bull run was warranted in terms of soybean supply/demand fundamentals. Were it not for the broad-based rally in all commodities, soybean prices, arguably, may have remained confined to much lower prices over the past two years.

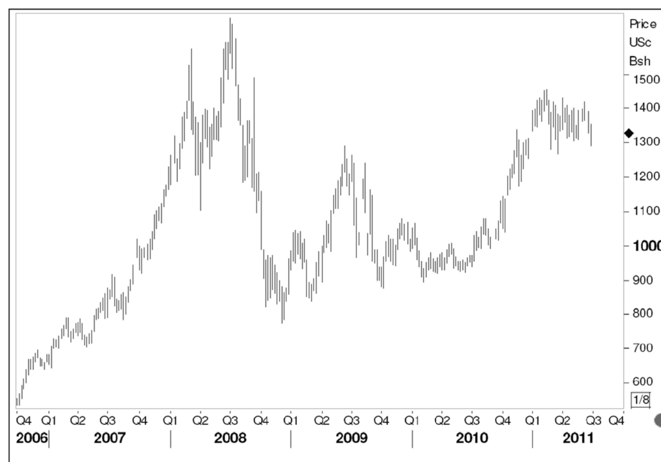
Traders focus heavily on US production and exports, which used to be astute when the US was by far the world's largest producer. But that has not been the case for about 10 years now, since South American producers expanded their crops exponentially. In 2008-09, global ending stocks fell to 19.2% of consumption, which was clearly a deviation from the historical norm and constituted *bona fide* tightness. After that, however, combined Brazilian and Argentinean production surged, from 90 million tonnes in 2008-09, to 123.5 million tonnes in 2009-10.

True, Asian buying took off as well, and there is always the gap between the time the US has sold most of its soybeans and the time that the South American harvests become available. But ending stock estimates were never really in danger of getting close to 2008-09 levels. In 2009-10 stocks ran up to 24.8% of usage, followed by further gains in 2010-11, to 25.22%.

The early USDA forecast for 2011-12 is for inventories to fall to 23.3% of consumption. That assumes that demand will grow by 3% over 2010-11. Perhaps, but that ending stock figure would still be above the 22.57% average of the previous 10 years.

In conclusion, soybean prices benefitted from the secular bull market in commodities, and more specifically from strength in related markets, such as corn. The fundamentals are not bullish, but it's been dangerous to be short anything, so we are hesitant to recommend an outright short position. Observe from the sidelines. *[June 24, 2011]*

Chart 6 – Weekly nearest contract soybeans



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COCOA

Can supply figures be overstated?

In early May, we asked, "Is peace in the Ivory Coast enough to tame the cocoa bull?" (See *Focus on Futures*, May 11). The answer was negative, but we suggested using a relatively conservative $2,900-per-tonne stop close to protect long positions. The market has had ample closes below that level, so we are out (Chart 7).

We are well past the ousting of the incumbent president, Laurent Gbagbo, who lost the election but refused to leave the presidential palace. About half the 470,000-tonne backlog of beans, held back by the winner of the election, Alassane Ouattara, to starve Mr. Gbagbo of revenues, has been shipped. Prices made new lows for the move as the impasse was resolved.

On the surface, it seemed fairly clear that the last vestiges of the bull were gone. According to official government estimates, the Ivory Coast was slated for a bumper crop. Ghanaian output (including beans smuggled from the Ivory coast) jumped an astounding 50% above the previous season's supply.

The demand side was not helpful either. First quarter grinding results from Europe and North America showed consumption was growing at a slower pace than production. Butter prices continue to slump, which means that there is no incentive for processors to buy more beans than they need to meet commitments.

Nevertheless, when viewed in the context of some serious bouts of across-the-board commodity weakness, with major corrections in even the strongest of markets, such as gold, corn, and petroleum, we observe that cocoa bean prices, with its alleged bearish fundamentals, held up rather well.

Most of the talk in the cocoa market has revolved around the 2010-11 Ivorian port arrival level, which is said to be running 15% ahead of last season at this time. That would put annual output at 1.3 million tonnes. Quite the amazing feat, considering all the turmoil that affected just about every facet of the production, mobility, and storage process.

We have absolutely no evidence to cast any doubt on the reporting of arrival figures. It is strange, however, that both the Ivory Coast and Ghana could post such fantastic numbers. Indeed, some market observers have suggested that a significant amount of Ghana's "production" estimate is in fact smuggled Ivorian cocoa. It is difficult to believe the authenticity of Ghanaian estimates while accepting that Ivorian farmers were able to compensate for labor – and other – problems associated with the civil war and produce such a large crop.

Ghanaian officials insist that the 900,000-tonne-plus crop is the result of a significant escalation of fertilizer use and that they have brought tree disease under control.

The first signs of poor quality cocoa in the Ivory Coast have emerged. Press reports claim that the most recent port arrival included 15,000 tonnes of beans that were not eligible for export at all. The export standard was always 105 beans per 100 grams. Ivorian officials have lowered the standard for this year's mid-crop to 125 beans per 100 grams citing "exceptional circumstances" as a result of the war.

So while the headlines may speak of extraordinary tonnage, the by-product content has obviously been compromised.

Second-quarter grind results for Europe and North America will be released in a few weeks. Even a small uptick will be bullish news, because we are now seeing an ever-increasing amount of origin grinding activity. Indonesian and Malaysian grindings are estimated to be 20% and 10%, respectively, above last year's.

If nothing else, the 2010-11 season has illustrated the vulnerability of the cocoa market to the Ivory Coast's position of being the provider of one third of the world's cocoa beans. We've muddled through, again, but just barely. It remains to be seen just how much of the 1.3 million tonnes is actually acceptable for Western chocolate manufacturers.

While commodity funds have generally been net-long commodities, cocoa has been an exception. Chart 8 shows that they are giving up and have begun to cover their short positions, which leaves a fair amount of short covering firepower to exacerbate the rally that we feel confident is around the corner.

The bull is hardly tame. We recommend re-entering the long side. *[June 29, 2011]*

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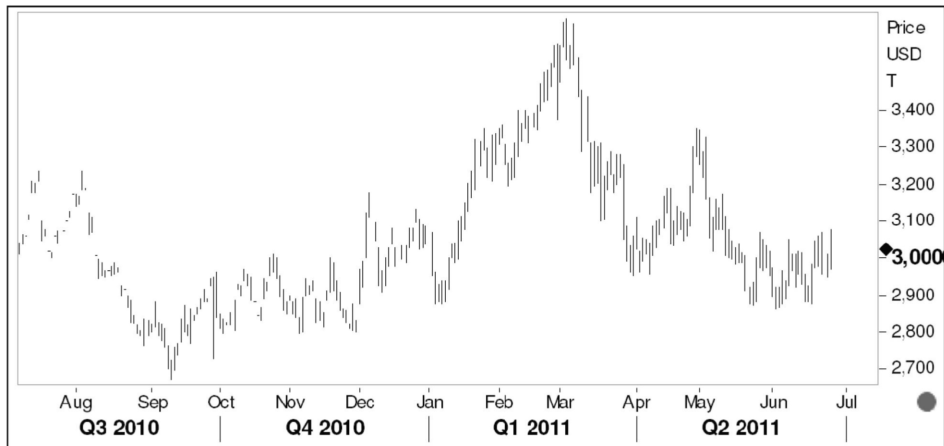
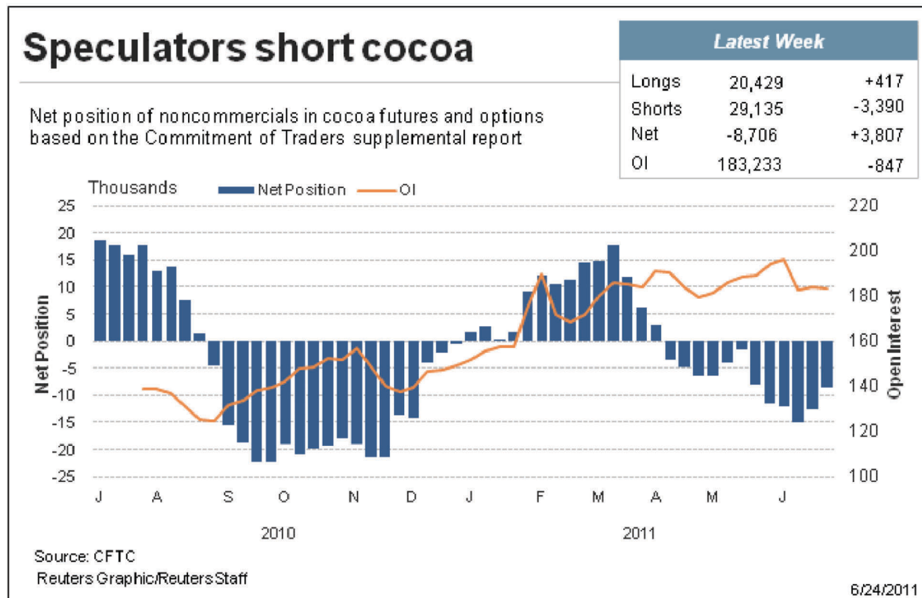
Chart 7 – September cocoa



Courtesy Reuters

Chart 8 – Commodity funds net-short ICE cocoa short position



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