

# FRIEDBERG'S

## FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 15, No. 4 July 2, 2012

## Is cotton oversold?

With the storm clouds of the European debt crisis threatening to wreak economic disaster far and wide, it's a bit difficult to focus on bullish fundamentals of individual markets. This is particularly true for any commodity whose fortunes are dependent on Chinese imports. With a softening Chinese economy and constant warnings that growth rates will continue to decline, potentially bullish arguments are sometimes overlooked.

The cotton market is a prime example. Strong old-crop US export sales took the market by surprise. Do they signal a bottom for cotton prices?

Actual usage data in China indeed show an unmistakable decline in economic activity, at least as regards cotton. For the current, 2011-12 marketing year, the estimate for Chinese domestic mill usage has fallen steadily – from an early-season forecast that reached as high as 48 million bales, to the most current reading of 41 million bales. Which fits perfectly with the slide we've seen in cotton prices (Chart 1).

Despite the apparent weak demand, the Chinese have committed to stockpile cotton, and the import statistics show this clearly. Early forecasts called for only 16 million bales of Chinese imports, but the most recent estimate in the USDA's June crop report was 23.25 million bales, revised upwards by 175,000 bales from the May estimate.

We're very late in the 2011-12 marketing year for cotton, which ends on July 31, yet old-crop US exports are still in high demand. For the first week of June, export commitments were just under 800,000 bales, one of the largest weekly tallies in history. We haven't seen a weekly number like that since April 2007. A typical week in the active part of the season sees sales in the 200,000-bale to 300,000-bale range. Of the total, 744,000 bales went to China.

Old-crop sales were flat the following week, but new-crop sales were 471,000 bales, still a very robust result.

The USDA again revised upward its estimate for US sales in the June crop report, by 200,000 bales, to 11.6 million bales. With commitments now at 12.5 million bales, that estimate will be subject to another revision. Shipments over the past four weeks averaged 250,000 bales. With the fresh jolt of old-crop sales, shipments will have to be con-

siderably higher than that to meet the USDA's target for annual sales. In any case, the flow of US exports has been much better than anticipated. If foreigners do not cancel any of their commitments, a rough calculation would put 2011-12 US ending stocks at or near record lows.

In looking ahead to the 2012-13 marketing year, we find that expectations of a recovery for the Chinese milling industry are running low. The USDA's first estimate in May was for zero growth, at 41 million bales, well below the historical norm. The June crop report revised that forecast down by 1 million bales. That would be the lowest Chinese cotton consumption since 2004-05. Certainly, if that scenario played out as predicted, we would see export sales dry up sooner or later because of the shopping spree we've witnessed over recent months. Using current estimates, Chinese ending stocks for 2012-13 would shoot up to 31 million bales, or a gargantuan 78% of usage.

Virtually all key producing countries have planted fewer acres for the 2012-13 crop year than they did for 2011-12. The US will harvest a larger crop than it did in 2011-12 regardless, because of the disastrous crop failure. So the global crop will be just a bit smaller than last year, but consumption will be down by 5% according to preliminary USDA estimates. That would leave a burdensome, record-by-far, 67%-of-usage global carryout.

### Inside

|  |   |
|--|---|
| <b>Corn:</b> Drought quashes record hopes..... | 2 |
| <b>Wheat:</b> Foreign crops disappoint .....   | 4 |
| <b>Soybeans:</b> Tightening inventories.....   | 5 |

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

**Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.**

#### Get Focus by e-mail

*Focus on Futures* is available by e-mail as an Adobe PDF file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please send us a message at [focus@friedberg.ca](mailto:focus@friedberg.ca) with your full name, e-mail address, and street address.

As a result, the extraordinary export activity notwithstanding, it's hard to make a convincing bullish case with the way the balance sheet looks now.

There are, however, two areas of vulnerability. It's early in the growing season, and the major producers must get through without crop problems. In addition, the assumption that Chinese mills will not use more than 40 million bales for the second consecutive year could turn out to be misplaced.

We believe that all the bearish possibilities are embedded in the new-crop prices. December cotton is trading at or below the cost of production. At one point this month, the spread between new- and old-crop prices soared to 13.5¢, and even after collapsing, still presents the opportunity to buy a substantial discount to spot prices (Chart 2).

Buy December cotton. Place initial stops at 74¢ per pound, close only. [June 22, 2012]

Chart 1 – December cotton



Courtesy Reuters

Chart 2 – July/December cotton spread



Courtesy Reuters

## CORN

# Drought quashes hope for a record 2012-13 US crop

The corn market is not following the script. New-crop prices have rallied more than \$1 per bushel in just over one week (Chart 3). The annual weather scare is in full force, although the timing is a bit off. The US crop was planted much earlier than typical, which was expected to shield the

crop from any early-autumn frost. What farmers did not anticipate was an early heat wave.

Normally the key pollination window comes in mid-July. Since the crop was planted so early, pollination will take place about two weeks earlier, which makes the weather in

the last week of June and the first week of July critical.

Temperatures in some key Midwest growing regions reached 100°F and are threatening to compromise forecasts for record bushel-per acre (bpa) yields. To get an idea of how this would affect the US corn harvest – and ultimately ending stocks – consider: The USDA’s June estimate was unchanged from the original May estimate, at 166 bpa. That would have been substantially higher than yields in 2011-12 and 2010-11 of 147.2 bpa and 152.8 bpa, respectively. The resulting crop would have been a record 14.790 billion bushels. The previous record was 13.092 billion bushels, grown in 2009-10.

The most recent crop progress report released on June 25 is not up to date with the effects of the weather of the past few days. But even so, the downgrade to the crop’s health was steep. The good-to-excellent portion of the crop fell to 56% from 63% the week before. Last year at this time, the good-to-excellent section was 68%. The July 2 progress report will almost certainly contain a further reduction in the estimate for the quality of the crop.

Naturally, the revised estimates are all over the map. If we get yields of 155 bpa – still considerably higher than the previous two seasons and the third highest on record – the estimate for the crop would fall by about 1 billion bushels. That would slash the forecast for ending stocks from the current estimate of 1.881 billion bushels, or 13.65% of consumption, to 880 million bushels, or 6.4% of consumption.

If the scenario materializes in Murphy’s Law fashion, it would prove to be a great disappointment for bears. The massive increase in acreage for the 2012-13 was expected to be the belated response to the explosive growth in ethanol consumption. Instead, the 6.4%-of-usage carryover would be the lowest US ending stock figure since the first leg of the bull

market began in 2007! (It’s not the lowest on record – that was in the mid-1990s bull market when the carryover sank to 5% of usage at the end the 1995-96 season.)

The impact to the global market is severe in terms of what had been expected of the US crop. Inventories would have been restored to more comfortable levels of 16.8% of usage according to the USDA’s June crop report. Instead, that figure falls back to 14.2%, which would be the lowest since the 1973-74 season.

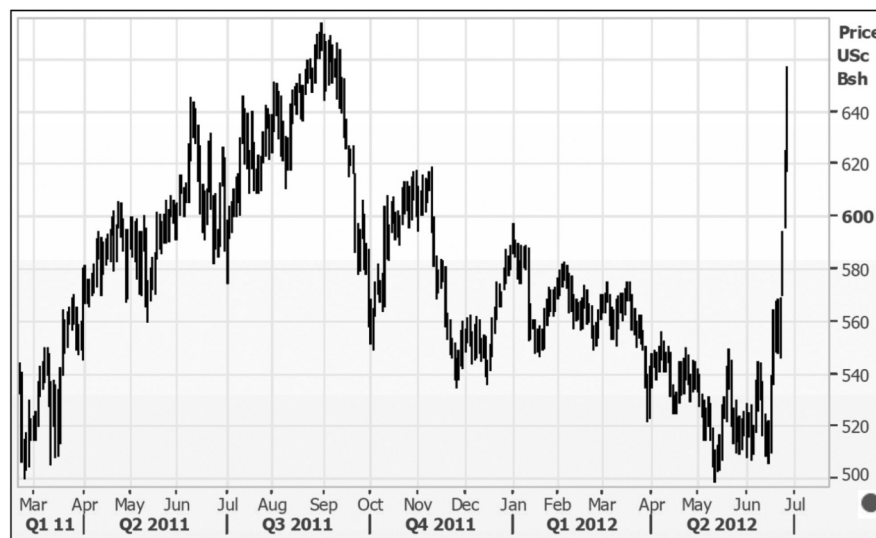
What are the sobering factors? In the June crop report the USDA raised its estimate for US 2011-12 ethanol usage by 50 million bushels, to 5.05 billion bushels. That was a bit of a surprise. However, in keeping with our belief that ethanol demand growth has peaked, its early forecast for 2012-13 is back to 5 billion bushels.

Furthermore, the USDA is anticipating a huge jump in exports for the new marketing year that begins in September. The early forecast calls for a 15% increase in foreign sales. If activity over the past few months is any indication, that is very optimistic. Aside from a 3.4-million-tonne single-week old- and new-crop spurt in early-May, sales have been sluggish. At the current pace, we’ll be lucky to meet the USDA target for 2011-12, which is already at a 10-year low. The four-week average for commitments has been 176,000 tonnes, but weekly commitments would have to be over 300,000 tonnes to make the estimate.

There’s much emotion that swirls around during weather scares. It’s hard to know how much damage was done. We’ve been bearish on this market, primarily because the extraordinary US crop was going to be introduced to the market just as demand had flattened out. We’re stopped out of our May 11 short sale recommendation, and we’ll stand aside for now.

[June 27, 2012]

Chart 3 – December corn



Courtesy Reuters

**WHEAT****Foreign crops disappoint**

Wheat prices, like the other grain markets, had an explosive rally over the past 10 days because of the oppressive heat in the US Midwest (Chart 4). The big question is this: How much of the spike is spillover from the corn pits?

The US winter wheat crop typically comprises about 75% of the total US crop. The crop is planted in the autumn and harvested the following spring and summer. As of the most recent crop progress report, 59% of the crop had been harvested, and by now that figure is much higher. Dry weather back in May is expected to have affected the crop to some degree, and the current heat wave will affect some unharvested wheat. Overall, though, the direct impact of the drought-like conditions on US wheat is not nearly as disastrous as it might be for corn.

The spring wheat crop has thus far been spared. The most recent crop condition report puts the good-to-excellent portion of the crop at 77%, which was actually up one percentage point from the previous week and higher than the 69% reading last year at this time.

The problems lie outside the US. Just about all major Northern Hemisphere producers are having supply issues with their 2012-13 winter wheat crop.

We've discussed the crop failures of FSU winter wheat crops in previous issues, and the estimates continue to slip. Output in the second- and third-largest FSU producers, the Ukraine and Kazakhstan, is expected to fall by a combined 16.85 million tonnes, or 37%, from last season. That's not news. The USDA did not change those estimates from May.

What is news, though, is that the inclement weather touched Russian growing areas, but, until recently, analysts did not expect much damage. That has changed. The June crop report slashed 3 million tonnes off the June estimate, to 53 million tonnes. Now private estimates have surfaced that cut an additional 3 million tonnes off the

Russian crop. Total FSU output would be about 92 million, down from 117.40 million tonnes in 2011-12.

The USDA estimates that FSU exports will fall to 29 million tonnes, from 37.6 million tonnes last season. With the recent crop revisions, that may be wishful thinking.

Official Chinese government sources have volunteered information that disease has affected the winter wheat crop. The accompanying estimate says that crop will be about 2.3 million tonnes below previous estimates. That seems a tad optimistic. Some private estimates put the crop losses at a staggering 15 million tonnes below the USDA estimate, or 105 million tonnes.

The June estimate for global ending stocks slipped to 27.2% of usage, down from 28% in 2011-12 and 30% in 2010-11. If these revisions for Asian output are correct, we're looking at a drop in inventories down to 24.5% of consumption. That would be the lowest carryout since the plunge in the 2006-07 and 2007-08 seasons to the 21% level triggered the massive bull market that sent wheat prices soaring to \$12 per bushel and beyond.

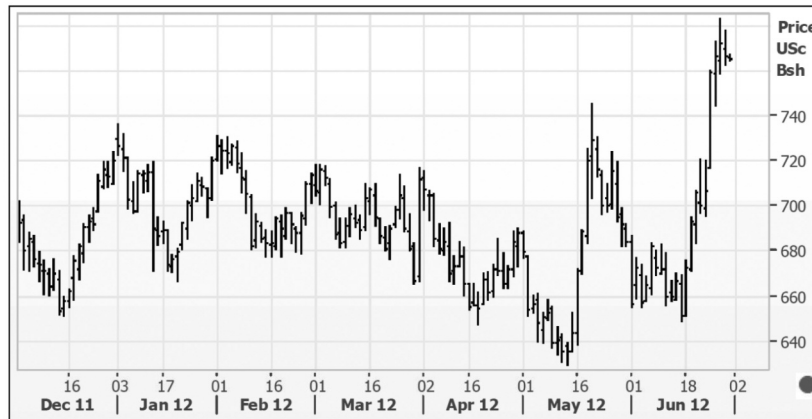
The current estimate for 2012-13 Chinese imports is 2.5 million tonnes. China will not hesitate to ensure ample domestic supplies. Imports in 2011-12 and 2010-11 were 22 million tonnes and 13 million tonnes, respectively. Unlike last season, FSU export capabilities – as illustrated – are limited.

The USDA estimate for US exports for the new marketing year have not ignored this situation. The early forecast is 31.3 million tonnes, up from 28.71 million tonnes in 2011-12. We expect that estimate to grow.

In conclusion, the rally in wheat probably did get a boost from the hot weather in the US. Wheat fundamentals, however, are obviously independently bullish.

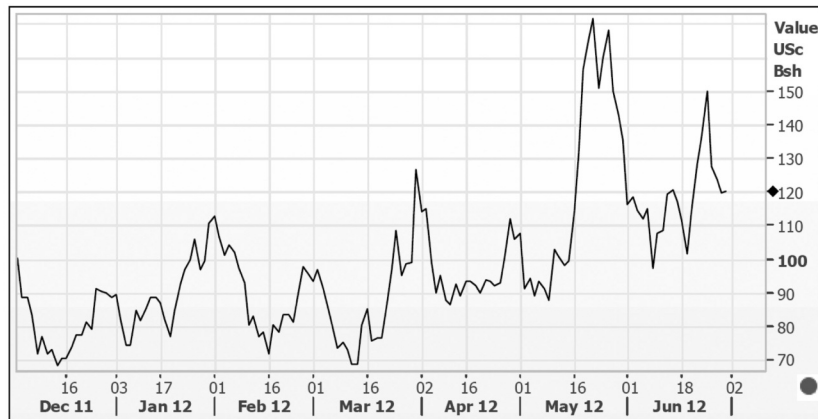
Maintain long December wheat positions, as well as long September wheat/short September corn spreads, as per our June 7 recommendation. *[June 29, 2012]*

Chart 4 – December wheat



Courtesy Reuters

Chart 5 – September wheat/corn spread



Courtesy Reuters

## SOYBEANS

### Inventories continue to tighten

Drought-like conditions across US soybean-growing regions have sent prices soaring (Chart 6). In the most recent crop progress report, the USDA lowered the good-to-excellent portion of the crop to 53%, three percentage points below the previous weekly reading, and down from 65% at this time last year.

Aside from damage done to the part of the crop that's already been planted, double cropping has been compromised. Farmers plant soybeans on some winter wheat acreage that has been harvested, and it is especially attractive when prices are high. Double cropping was expected to reach 8% of the total crop, which would be near the high

end of the historical range. But with very low soil moisture levels, many of those acres will not get planted.

The much-anticipated quarter-end reports were both bearish. Quarterly stocks as of June 1 were 667 million bushels (18 million tonnes), 32.5 million bushels (885,000 tonnes) above the average analysts' guesstimate.

The acreage estimate was expected to be well above the March 31 planting intentions of 73.902 million acres, but the figure came in at 76.08 million acres, 572,000 acres above the average guesstimate. Using the USDA's yield estimate, that works out to an extra 25 million bushels (680,000 tonnes). Between the two reports, that's a lot of

extra soybeans in terms of US ending stocks.

When the news first hit the wires, the market sold off, but only momentarily. We believe that it is obvious that the data in both reports are dated. The acreage report tells us the number of acres, but nothing about yield. The USDA estimate for yield is 43.9 bushels per acre (bpa), just a tad below the 44-bpa record yield of 2009-10. The five-year average was 42.1 bpa, and considering the weather the crop is getting, that is likely where yield estimates will be headed over the next couple of crop reports.

Furthermore, as mentioned above, we'll probably lose 1 to 2 million acres of the double crop, and that has not been factored into this acreage report either.

As far as quarterly stocks are concerned, export sales continue to be strong and much better than the USDA estimate, so that number could very well be overstated. Commitments stand at 37.3 million tonnes, well above the USDA target of 36.33 million tonnes. To meet the commitment, exporters would have to ship over 400,000

tonnes per week until the end of the marketing year on August 31. The average of the past four weeks has been 370,000 tonnes.

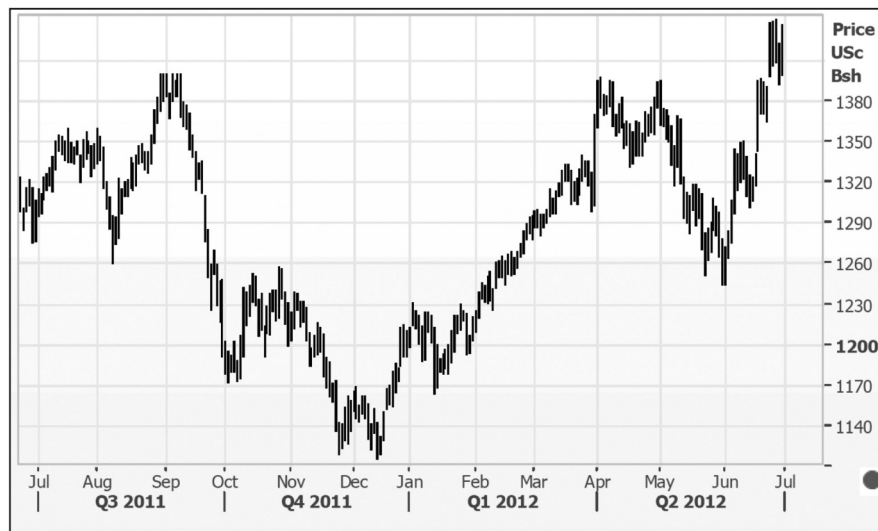
The early USDA forecast is calling for a 10% increase in new-crop exports. US exporters have already booked 12.388 million tonnes, significantly higher than early new-crop sales last year at this time of 7.5 million tonnes. Demand is strong.

In the June crop report, the USDA lowered its estimate for the beleaguered, recently-harvested 2011-12 Argentinean crop by 1 million tonnes, to 41.5 million tonnes. That compares with 49 million tonnes in 2010-11.

The current estimate for global ending stocks is 22% of usage. That's near the low end of the range of recent years and not far from the levels that sent soybean prices to \$16 per bushel.

Remain long November soybeans. Raise stops to \$13.80 per bushel from \$12.50 per bushel recommended on May 29. Close only. [June 29, 2012]

Chart 6 – November soybeans



Courtesy Reuters

Friedberg's Focus on Futures is published by Friedberg Mercantile Group Ltd., P.O. Box 866, Suite 250, 181 Bay Street, Toronto, Ontario, M5J 2T3. Contents copyright © 2012 by Friedberg Mercantile Group Ltd. All rights reserved. Reproduction in whole or in part without permission is prohibited. Brief extracts may be made with due acknowledgement. Friedberg Commodity Management Inc., an NFA registered CTA, takes full responsibility for the contents of this publication.

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

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

All statements made herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate. Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.