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Cocoa: A smaller Ivorian crop is in the bag

Unrest in the Ivory Coast dominated cocoa market headlines this week. Pro-government militia attacked rebel forces, igniting fears that the fighting would spread and eventually hamper the smooth flow of crops to port. Also, some farmers, fed up with what they feel are too-low farm-gate prices, are striking, hoping that the government will increase subsidies.

Indeed, the recent rally (Chart 1) coincided with these stories. But we've been long because we think the supply/demand fundamentals were bullish with or without these developments. The violence has not affected transportation in the past, and there is nothing to suggest that it will in the future. The labor unrest may be more of a real issue. Earlier in the season, the walkouts slowed arrivals, which could compromise quality while beans are not stored properly as they await shipment. Still, the strikes have been limited, and we don't expect any serious supply problems to result.

We are near the end of the main crop, and we are lagging last year's arrival pace by a wide margin. As of the most recently available data released on March 3, arrivals stand at 876,980 tonnes, 10.9% behind last year at this time. This represents an improvement from previous data, published on February 16, which showed arrivals running 11.5% behind last year. But there is very little time for the gap to narrow much more from here on in.

A rough calculation for a crop that would be 10% smaller than 2003-04, coupled with the fact that the other major producers, such as Indonesia and Ghana, are expecting similar-size crops, shows we are looking at a substantial draw-down of global stocks.

On March 2, the International Cocoa Organization (ICCO) said that we would have a global deficit in 2004-05 of 50,000 tonnes. This compares with a surplus in 2003-04 of 233,000 tonnes. In its December forecast, the ICCO said merely that we would have a smaller surplus than 2003-04. Output will drop by 258,000 tonnes, or 7.4%, to 3.215 million tonnes. Demand will grow by a scant 28,000 tonnes, or less than 1%, to 3.233 million tonnes. Global ending stocks will fall to 1.368 million tonnes, or 42.3% of consumption, down from 2003-04 inventories of 1.418 million tonnes, or 44.2% of consumption.

With the information available at this time, the ICCO production estimate looks about right. We'll be down about 150,000 in the Ivory coast and smaller amounts for other producers. The demand side estimate, however, seems low to us. Quarterly grind data have not confirmed any substantial growth in consumption, but butter ratios in Europe are holding very steady at three times London spot. After the year-end holiday buying rush, it was believed that the demand for butter would slacken, but it clearly has not.

On the other hand, the contango between the futures delivery months, although very tight for a market that is supposedly awash in carryover stocks, has been eroding and has not improved with the recent runup in price.

Probably the most extraordinary issue in this market at present is the behavior of commodity funds. Already heavily net long, they are piling on more. Open interest jumped 11,000 contracts in one day this week. While we're not certain that it was a one-day record, we don't remember a one-day move in open interest of that size – up or down.

Because the ICCO seems to have captured the essence of the changes in the supply side, we can probably assume that the 1.5-million-tonne drop in the Ivorian crop to 13.5 million

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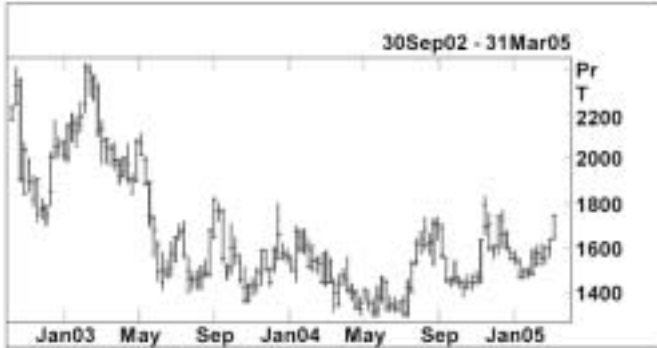
tonnes is in the market. Anything smaller than 13.5 million tonnes would be fresh bullish news. On the demand side, anecdotal evidence of butter ratios is neutralized by a widening contango.

Certainly, while the funds are supporting the market and old resistance levels fall by the wayside, bulls can remain

long this market. Bearish open interest signals, however, should be monitored carefully for any sign that the funds are getting ready to liquidate. [March 4, 2005]

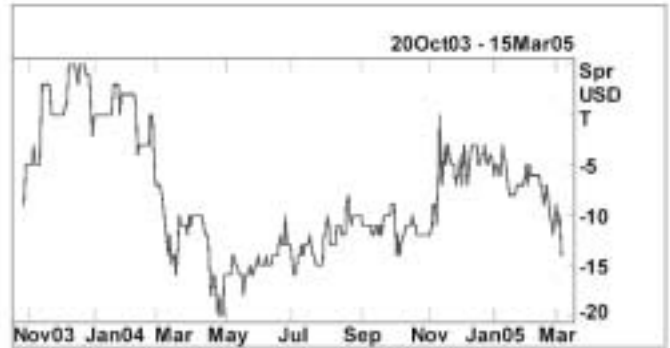
CURREST STRATEGY: Liquidated May cocoa, as per Flash Update of March 24.

Chart 1 – May cocoa



Courtesy Reuters

Chart 2 – May/July cocoa spread



Courtesy Reuters

COPPER

Global deficit set to shrink

It would seem almost ludicrous to attempt to build a bearish case for copper as long as we continue to run a huge production/consumption deficit. While the global economy is not booming, it has been growing at a very steady pace and most indications are that this is likely to continue for the foreseeable future – particularly in China – which should maintain the strong demand that has fueled this bull market. Inventories at the three principal exchange warehouse systems remain at their lowest levels in years.

The chart paints a perfectly bullish technical picture (Chart 3). Prices recovered from the January 4, one-day, 12.5¢ massacre in fine fashion. The low of that session was the low of the correction. The market has never looked back and has proceeded to make fresh contract highs.

Trying to pick tops (or bottoms) in markets is a messy business and rarely yields profitable results, at least in our experience. Conventional wisdom dictates that traders with strong opinions that a trend is in transition are – on balance – better off waiting for a meaningful reversal.

Nevertheless, recent developments in this market could be indicating that copper is in the early stages of forming a top. In February, The International Copper Study Group (ICSG) recorded a large increase in the global production/consumption deficit for the January-through-November period, to 832,000 tonnes, the highest deficit estimate to that point in 2004. Prices rallied 15¢ per pound on their way to new contract highs. The March ICSG report then confused market participants with the final data for 2004, which showed a sharp drop in the deficit to 706,000 tonnes, a fairly big move for a one-month period.

Chile mines about one third of the world's copper. It is abundantly clear from monthly output statistics that mining companies have responded to high prices by cranking out as much copper as they can. Global mine output grew 2.5% in 2004, while usage increased 5.5% over 2003. But Chilean mine output has been growing at a pace that, if sustained, would dwarf the growth in consumption. Over the past six months, Chilean production has increased at an average monthly rate of 14.25%. Even if we extract the extraordinary month in which output was up 19.3% (August), we are still looking at an average monthly increase of 13.25%.

Unless one is of the opinion that the economies of copper-importing countries are going to grow at a considerably faster clip in 2005 than they did in 2004, which would accommodate a higher rate of consumption growth than 5.5%, one has to be skeptical about the ability of the market to maintain current price levels.

Mining companies are not likely to worry about creating a supply glut that would drive prices down, because they have a huge buffer between where prices are now and price levels that would threaten profitability.

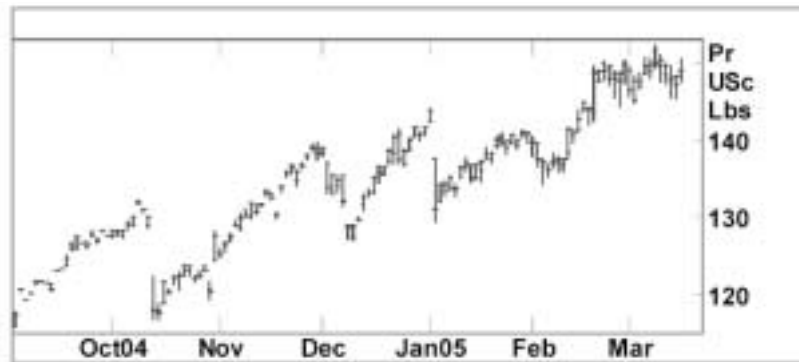
In January, we discussed the divergence between the cash-to-three-month spreads at COMEX and the LME. The backwardation that accompanied this bull market began to disappear in New York (Chart 4), but was getting even wider in London. It was easy enough to build a case in which the market was no longer tight and prices were being held up by commodity funds falling over themselves trying to get long positions in commodities – any commodity. This would

explain the weakening spreads in New York, but then what was the tightness in London telling us? Now, the backwardation in London has come off as well, falling from \$183 per tonne to its current \$120 per tonne (Chart 5).

We believe that the bullish supply/demand data that

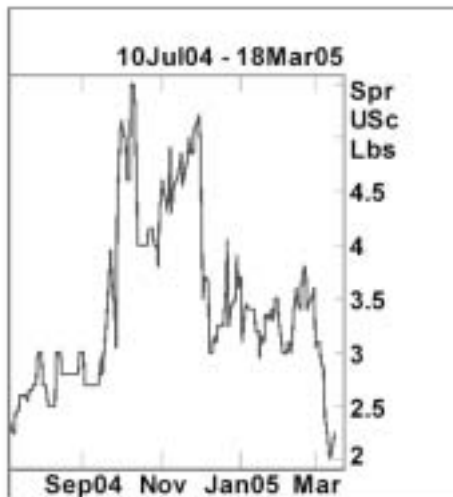
make headlines is lagging current realities, as illustrated. Bearish traders should be prepared – emotionally and financially – to be disappointed several times before they get it right. A \$1.50-per-pound copper is not sustainable. Perseverance will pay off. *[March 16, 2005]*

Chart 3 – May copper



Courtesy Reuters

Chart 4 – Comex May/July spread, 10 July 04 - 18 March 05



Courtesy Reuters

Chart 5 – LME cash/3-month spread, 30 October 04 - 17 March 05



Courtesy Reuters

SUGAR

Commodity funds keep sugar rally alive, for now

During 2004, open interest totals for commodity futures shot through the roof. The only exceptions were the smaller, illiquid markets, such as oats and orange juice, which are of little interest to commodity funds.

Recently formed commodity pools, which include the traditional trend-following funds and the newer index funds, have participated in the move to the “alternative investment class” phenomenon and have poured billions of dollars into the futures markets. It seems that the representation of bona fide supply/demand fundamentals could become distorted. Indeed, in the short run this is almost certainly true and man-

ifests itself in terms of exaggerated price movements, but ultimately major trends should head in the direction of underlying fundamentals.

The sugar market is one of the prime examples of how the influx of huge sums of money has affected trading but has only delayed the reflection of supply and demand factors on price. Until early 2003, the highest open interest on record was 225,000 contracts. Prices rose to the 9¢-per-pound level from 5¢, and the bull run was accompanied by an increase in open interest of more than 200,000 contracts to 425,000 contracts.

The rally was well warranted, because the global sup-

ply/demand balance swung from a 5-million-tonne global surplus in 2002-03 to a deficit market in 2004-05. There were two primary issues. The fantastic rise in crude oil prices caused increased demand for more-economical, sugar-based ethanol in countries with well advanced bio-fuel programs, such as Brazil, and pushed countries with less advanced programs to hasten the pace of developing the commercial viability of ethanol consuming vehicles.

Brazilian ethanol output is expected to rise by 10% during 2005-06, which will reduce the amount of sugar available for export. No other country has forced consumers into using as high a ratio of bio-fuel to petroleum, but collectively, the numbers are growing. France, for example, recently announced a plan to triple its bio-fuel output by 2008, 70% of which will be sugar-based ethanol.

Then, India – traditionally a self-sufficient sugar consumer – had two consecutive crop failures, which forced it to draw down its once burdensome inventories and to turn to imports to beef up supplies and dampen rising domestic prices.

Recent revisions to the 2004-05 global production/consumption deficit by all the major sugar analysts continue to point a tight market.

Yet with all the potentially bullish developments circulating in the press every day, sugar prices have not been able to penetrate the 9.35¢-per-pound resistance level established over the past six months. Hard as commodity funds have tried, the knowledge and greater staying power of commercial interests have prevailed.

Importers have just not displayed any urgency. The evidence can be seen clearly in the inter-month spreads. Chart 7 illustrates how the May/July spread has gone from backwardation to a full carrying charge market.

A big part of the bullish case for sugar was the Indian situation. After all, the country moved from a string of 20-million-tonne crops and balanced markets to 2 years of 13-million-tonne crops and huge deficits. Indeed, India has been importing sugar and will probably buy more.

But time is running out for the Indian shortfall to have a bullish impact on prices. Although the 2005-06 crop will not be harvested until much later this year, it is expected to stage a not-quite-complete, but still significant, recovery. Early estimates are looking for output of 18 million tonnes. While it is quite early, a full recovery would eliminate the bullish Indian factor completely.

To be sure, many plausible bullish factors still exist. Ethanol consumption will continue to grow. Even if crude oil were to slip back further, say to the \$40- to \$45-per-barrel range, bio-fuel alternatives would still represent savings for consumers.

China does not hold any significant stockpile of sugar. It has a precariously tight production/consumption ratio and could easily emerge as a buyer at any moment.

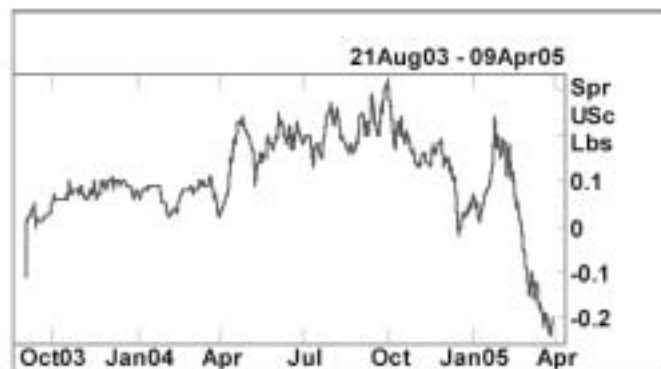
The sequence of events did not differ that much from the pre-hedge-fund days. The bullish fundamentals asserted themselves, and probably overstayed their welcome. With a brighter outlook for Indian production, the market has now begun a counter-trend correction.

Chart 6 – Sugar open interest



Courtesy CQG

Chart 7 – May/July spread, 21 August 03 - 09 April 05



Courtesy Reuters

SOYBEANS

Seeing through the volatility

The soybean market's *initial* reaction to a series of USDA reports on March 31 was confusing. First and foremost, the long awaited planting-intentions report – which was the headline-grabbing item – should have been bearish for prices. US farmers will plant 73.91 million acres to soybeans for the

2005-06 marketing year. Although this will be 1.3 million acres below last year's final planted-acre tally, the street was looking for an even lower number (73.37 million acres) because of the arrival of soybean rust in the US. Previously, the dreaded airborne agricultural disease was contained in

South America, but last year was discovered to have made the long trip north. It was believed that farmers would replace a significant amount of soybean crops with corn or cotton crops where possible.

The story, however, lies in the italicization of "initial" in the previous paragraph. May soybeans were up by as much as 20¢ per bushel, to a 2-week high at one point of the session, but started to fade towards the end of the session and closed out the day with a 13¢-per-bushel loss. The slide takes the market right back to the low end of the recent range (Chart 8).

The data were not all bad. Quarterly stocks, as of March 1, came in at 1.38 billion bushels, compared with trade estimates of 1.425 billion bushels.

In combining the two reports and translating the data into tonnes, we find that the net result was actually bullish. We used a 38.1-bushel-per-acre yield (the average of the past three seasons). The difference between the actual number of 73.91 million acres and expectations for 73.37 million acres – assuming reasonable weather conditions – would be 560,000 tonnes. The difference between the quarterly stock figure and analysts' estimates would represent 1.226 million tonnes. When these data find their way into the 2005-06 US balance sheet, ending stocks would be lower by 666,000 tonnes (2004-05 ending stocks were 11.16 million tonnes). While this is not an overwhelming amount of soybeans to be dropped off the supply side, it would certainly render the net implication of these two reports bullish.

Like many other markets, (see *Focus on Futures*, March 30), the fundamentals of futures markets can be masked by the activity of large commodity funds to a greater degree than they were in any other period in history, and certainly, the soybean market is no exception. At 300,000 contracts, open interest is at a record high. Is it really possible for the interpretation of these reports to have been so bullish in the morning and to have turned bearish by mid-afternoon? Obviously not.

So despite the negative outcome of the trading session on the release day of these government reports, we believe that the overall uptrend the market achieved in the months leading up to this report remains intact. Traders are sure to gun for the gap in May soybeans left in late February – between \$6.11 and \$6.04 per bushel – which is likely to facilitate a fair amount of long

liquidation. We'd like to concentrate on the hard facts.

In its March supply/demand situation report, the USDA lowered its Brazilian estimate ever so cautiously, by 4 million tonnes, to 59 million tonnes. But the dry weather took a heavy toll, and according to more recent estimates by local analysts, we're looking at a much steeper revision come the April 8 monthly update. One estimate is calling for a Brazilian crop as low 52.3 million tonnes.

While Brazil and Argentina have clearly changed the face of the soybean supply channel over the past three seasons, a bit of the punch has come out of the mystique of the South American agricultural miracle, especially as it pertains to soybeans. This will be the second consecutive season in which we started the Southern Hemisphere crop year with predictions of huge Brazilian crops of close to 65 million tonnes. True, the weather is unpredictable, but it has not yet been proven that Brazil can harvest a crop anywhere close to the capacity represented by its planted acreage.

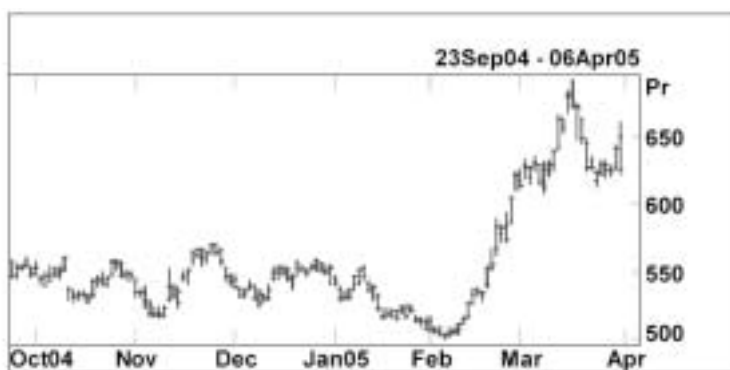
In a sense, the Brazil issue is irrelevant for now, because the harvest is well advanced. Whatever the crop size really is, it has more than likely already been reflected in the sharp rally we had while weather conditions in Brazil were deteriorating.

Putting together today's US data (a 1.226 million tonne drop in inventories) and using a 54-million-tonne crop for Brazil, we can expect to see the April estimate for global ending stocks for 2004-05 fall to about 50 million tonnes, or 24.4% of consumption, compared with 27.7% in the March report.

Despite a rather poor showing in this week's export report, commitments for the year stand at 27 million tonnes, and are running well ahead of the pace needed to meet the USDA's estimate for annual exports of 28.44 million tonnes. With five months left to the soybean marketing year, we'd have to say that export demand looks pretty good. In addition, let's remember that the lower-than-expected quarterly stock figure is a reflection of domestic demand.

In conclusion, we've identified a period of greater-than-normal volatility, but we've also presented a bullish view based on lower-than-expected supplies and strong demand. It would therefore be wise to allow the market to cover its gaps and whatever other housecleaning is necessary, but also to be prepared to buy sharp dips. [April 1, 2005]

Chart 8 – May soybeans



Courtesy Reuters

HOTLINE UPDATE

Monday, February 28, 2005:

Good afternoon for Monday, February 28, 12:25 pm. We have liquidated our long May cocoa position at 1741.

Friday, March 4, 2005:

Good afternoon for Friday, March 4, 4:20 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On February 28, we liquidated our long May cocoa position at 1741. We are currently holding no positions.

Flash Update – Monday, March 7, 2005:

Good morning for Monday, March 7, 9:05 am. This is a Flash Update. We have purchased May cocoa at 1740, placing our initial stop at 1650, close only.

Friday, March 11, 2005:

Good afternoon for Friday, March 11, 4:45 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On March 7, we purchased May cocoa at 1740. We are currently long May cocoa at 1740, with our initial stop at 1650. All stops are close only.

Friday, March 18, 2005:

Good afternoon for Friday, March 18, 4:40 pm. The following is a recap of our latest recommendations and stop levels. We are currently long May cocoa at 1740, with our stop at 1650. All stops are close only.

Flash Update – Wednesday, March 23, 2005:

Good morning for Wednesday, March 23, 9:20 am. This is a Flash Update. We have liquidated our long May cocoa position at 1630.

Thursday, March 24, 2005:

Good afternoon for Thursday, March 24, 4:45 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels. On March 23, we liquidated our long May cocoa position at 1630. We are currently holding no positions.

Friday, April 1, 2005:

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

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