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## FOCUS ON FUTURES

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## The copper bull grows weary

The bull market in copper has correctly been attributed to explosive demand, primarily from China and India. The economies of these and other Asian countries are certainly growing faster than any other region, and the volume of copper imports has been commensurate with that growth. This was certainly true at one point. Lackluster demand in other regions, however, has become a drag on overall global consumption, and the data show it.

According to the International Copper Study Group's (ICSG) most recent report, released on February 17, consumption of refined copper from January through November 2005 actually fell by 1.5%, to 15.16 million tonnes, from 15.39 million tonnes in the same period a year earlier.

The other side of the balance sheet might come as a surprise to some as well. Despite many months of flat production growth by Chilean mines, total global mine output in the January through October period was 13.48 million tonnes, compared with 13.16 million tonnes in the same period in 2004, a 2.4% increase.

Regardless, the world is still consuming more copper than it is producing, with the year-to-date deficit currently at 154,000 tonnes. But we should bear in mind that ICSG data are always three months old and present conditions are not necessarily reflected accurately.

Just about all barometers that we use to monitor developments in the supply/demand picture for the copper market have turned bearish.

First, warehouse stocks, which dropped to about 10% of the peak reached early this decade, have begun to creep upwards. LME stocks, which stand at 106,000 tonnes, have more than quadrupled since last summer. Still dramatically shy of the 1-million-tonne high, the trend is encouraging and is apparent at the other two exchange warehouse systems as well.

At COMEX, inventories rose from early December lows of a mere 4,000 tonnes to their present 33,000-tonne level. And Shanghai stocks have built from last summer's 20,000-

tonne low to the current 59,000-tonne level (Charts 1 and 2).

All told, visible warehouse stocks have increased from a global total of 50,000 tonnes six months ago to the present 200,000 tonnes.

Chilean output has been very weak. On January 27, after many months of falling mine production, the government finally reported a 6.6% year-over-year uptick for December, the largest increase since March 2005 when output grew by 2.8%. This still pales in comparison to 2004 mine output when monthly production increases averaged about 10%. Nevertheless, it is some indication that astronomically high copper prices may finally be inspiring the kind of mining activity that we expected to emerge sooner or later.

Most intriguing, and perhaps the best indication that current prices are not sustainable, is the collapse of inter-month spreads in both New York and London (Charts 3 and 4). There seems to be very little of the pent-up demand that should be characteristic of an explosive bull market.

One aspect of this market that is somewhat puzzling and should be disconcerting for those of us looking for a bearish angle is the activity of commodity funds. An analysis of the open interest reveals that the fund community has shown sur-

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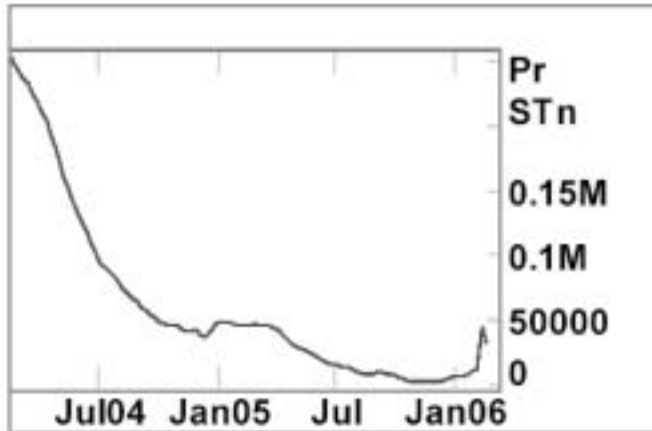
prisingly little interest in the long side of this market. The funds have maintained a very moderate long position since abandoning the long side way back in March 2005 when the market was trading around the \$1.5-per-pound level. This means, of course, that knowledgeable commercial interests have not been active sellers, which is what one would want to see as a tipoff that the bull has run its course.

Still, the market is clearly in transition. ICSG estimates

that the refined production/consumption deficit for 2005 will shrink to 122,000 tonnes (843,000 tonnes for 2004) and, based on current trends, projects a 295,000-tonne *surplus* for 2006.

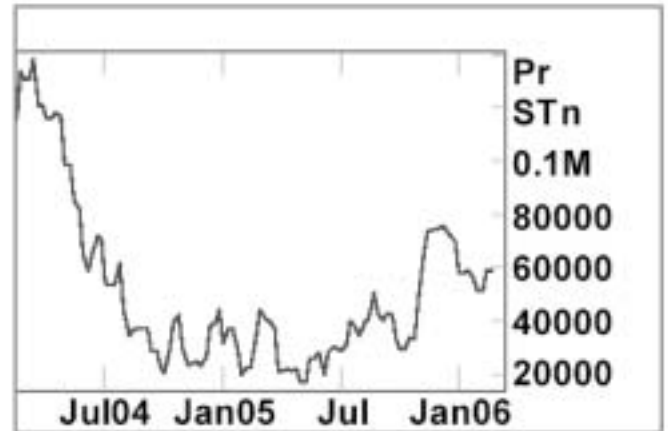
Maintaining a conservative short position via bear spreads has been a winning strategy, and we advise rolling short March/long May to short May/long July immediately so as to avoid a short-term squeeze that could develop as March heads into expiry. [February 17, 2006]

Chart 1 – Comex stocks



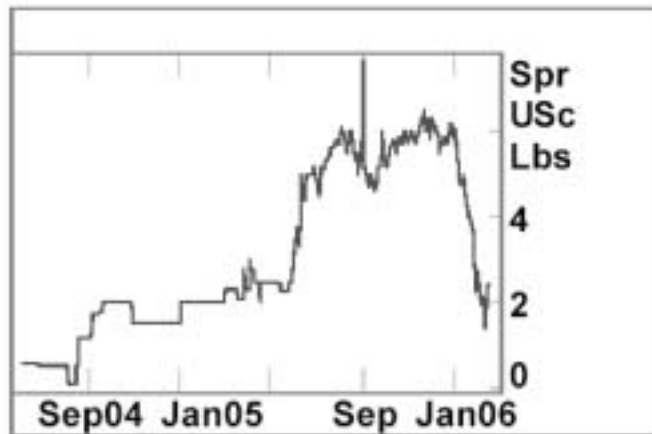
Courtesy Reuters

Chart 2 – Shanghai stocks



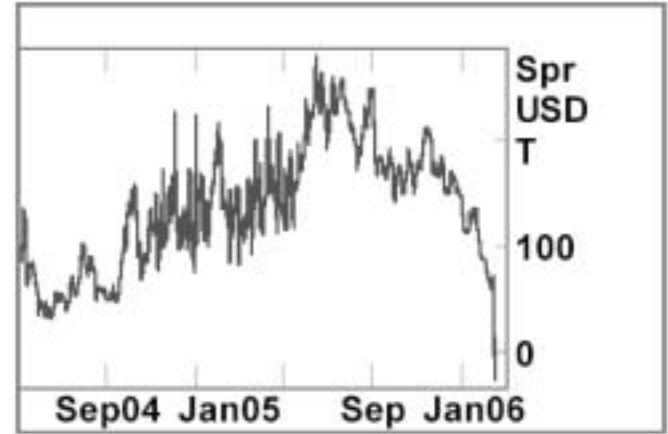
Courtesy Reuters

Chart 3 – March/May copper



Courtesy Reuters

Chart 4 – Cash/3 months



Courtesy Reuters

## COTTON

# Chinese demand eats right through great crops

Supply-side developments for cotton are screaming “bear.” Yet market activity is telling a different story.

The market shrugged off a record 2005-06 US crop. Early season estimates were way off the mark. Weather fears – in particular, uncertainty about damage caused by the extra-

ordinary hurricane season in the Southern US – kept estimates very conservative until harvest time. But as the harvest progressed, it became obvious that although yields would not match record results achieved in 2004-05 of 855 lbs. per acre, they would come pretty close, with yields of 831 lbs. per

acre. With acreage expanded over the previous season, the US was able to produce a record crop of 23.72 million bales.

When word of the larger-than-anticipated Chinese crop first surfaced in early February, the market reacted accordingly, with a 2.5¢-per-pound selloff from multi-month highs. The Chinese State Statistics Bureau revised its estimate for the 2005-06 crop to 26.2 million bales. The USDA estimate for January was 24.5 million bales. But March cotton has since come back to make new highs and maintain the uptrend.

The bullish story of course lies on the demand side. The USDA has set the bar fairly high by forecasting that the US will export 16.4 million bales of cotton in the 2005-06 marketing year, which ends July 31. This is significantly higher than 2004-05 final shipments of 14.41 million bales, which was also a record at the time. Weekly export commitment figures have been robust, averaging more than 400,000 bales over the past four weeks.

Expectations for a 14% increase in annual exports seems ambitious, and although it does pose quite a challenge, current statistics illustrate that it can be achieved. Total commitments to date are running about 17% ahead of last year at this time, which is in line with the forecast.

Shipments are also ahead of last year's pace – by 25%. Just to put things in perspective, that's less than 40% of the total, so there's ample room – and time – for things to go wrong and have cancellations spoil the picture.

Nevertheless, this is the reason the market remains so strong in the face of a rather bearish looking global balance sheet.

The Chinese production revision was the main factor in the increase in the USDA's estimate for 2005-06 global ending stocks to 52.93 million bales, 2.16 million bales above the January estimate. The impact of the increase in supply, however, was tempered by a 1.55-million bale increase in the consumption estimate. As a result, stocks as a percentage of consumption will rise only moderately, to 45% from January's 44% and will remain below 2004-05 ending stocks of 50% of consumption.

To appreciate the increase in Chinese demand, consider that domestic demand – which in China's case includes both cotton that will remain at home and a significant percentage of which will be exported in the form of textile and clothing – has grown to 45 million bales from 38 million bales in only two years!

To date, the Chinese have contracted to purchase 6.1 million bales of US cotton for 2005-06, with a bit less than half of that already shipped. This compares with shipments of just over 3 million bales for all of 2004-05.

The USDA's Outlook Forum held earlier this month issued some broad forecasts for the 2006-07 marketing year. Among them was an estimate of Chinese cotton demand to grow further, to 49.5 million bales.

In conclusion, the bearish news that China grew a larger crop than the market had previously believed is hardly bearish when measured against its strong consumption growth.

We advise maintaining a long position. This is a very volatile market, though, so we suggest moderate-sized – and therefore sustainable – positions. *[February 23, 2006]*

Chart 5 – March cotton



Courtesy Reuters

**COCOA****Ivorian output disappoints**

Technically speaking, the cocoa market is presenting a rather bearish picture. The recent rally failed, and the market is now trading below the low end of the short-term range (Chart 6). Commodity funds made a halfhearted attempt at establishing a presence on the long side, but the most recent Commitment of Traders report seems to indicate that their patience wore thin and that they are in the process of unwinding that position.

Developing supply-side fundamentals, however, tell a different story.

Port arrivals in the Ivory Coast as of February 27 stand at 880,000 tonnes, compared with 810,000 tonnes at this time last year. While that may still be 9% larger than last year, the gap has narrowed considerably, and main crop arrivals are down to a trickle.

Consider the contrast between February arrivals this year and last: Last year, arrivals increased by more than 150,000 from January 27 through February 27, and by the end of March had reached 950,000 tonnes. This year, February arrivals totaled only 75,000 tonnes.

In a typical year, arrivals continue strong well into sometime in March, but the crop was early this season, and we probably will not see many more main crop arrivals from here on in, as evidenced by the slow pace over the past two months. So barring the sudden appearance of a large amount of beans that are in hiding, we can safely assume that the main crop was a disappointment.

At this point there is a good chance that the mid-crop will put in a fairly good performance. Some analysts are talking about 300,000 tonnes. This may be a bit of a stretch, but in the absence of any surprises we should see a healthy mid-crop. Still, even an optimally sized mid-crop will leave total production at about last year's output level.

As such, estimates for the global balance sheet, which previously were looking for a 2005-06 deficit of about 100,000 tonnes, need to be revised. E.D.&F. Man, which sets the standard for cocoa data, released its first estimate of the 2005-06 on February 21.

Among major producing countries, only Ghana is expected to have a larger crop than last season, by about 50,000 tonnes. But cumulative output in the Ivory Coast, Indonesia,

Nigeria, and Brazil should be about 135,000 below last year.

Total global output is expected to fall to 3.216 million tonnes, down 93,000 tonnes, or 3%, from 2004-05. Global consumption as measured by grindings, however, is estimated to *increase* by 90,000 tonnes, or 3%, to 3.411 million tonnes, leaving a production/consumption deficit of 221,000 tonnes. This compares with a deficit of 38,000 tonnes at the end of 2004-05 and a surplus of 262,000 tonnes for 2003-04.

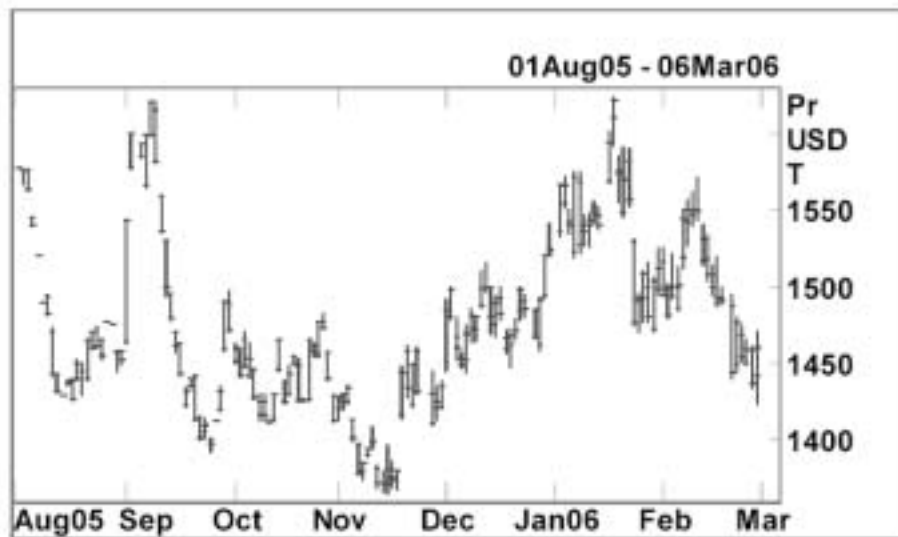
The revised numbers bring the global stocks-to-consumption ratio down closer to 40%. Although this is still quite high relative to other commodity markets, we need to keep reminding ourselves that this market is very much unlike most other commodity markets. The Ivory Coast, a rather embattled country, accounts for 37% of global production. And it, with three of its neighbors – all in the same climatic region – comprise 67% of global production. The high inventory level is a permanent and necessary fixture of this market. As we witnessed in 2003, the bull market trigger occurs at much higher inventory levels than we are accustomed to for commodities whose production bases are spread more evenly around the globe.

Near-term demand fundamentals have softened over the past two months and may help to explain the market's sluggish behavior. When cocoa butter supplies tightened last year and ratios soared to all time highs of over three times the London spot price, the attractive product prices provided an incentive to grind – perhaps a bit too much. Butter supplies are now ample, and the ratio has fallen to 2.4 in Asia and 2.6 in Europe.

Although there is no compelling reason to run out and buy cocoa at this moment, we believe that until the market takes out major support at \$1,300 per tonne, we remain in a long-term bull market that began when the Ivory Coast political infrastructure slipped into crisis earlier this decade. Despite the fact that Ivorian production continues to muddle through, the performance of this year's crop is evidence that production has likely peaked. Although other producing countries have announced ambitious plans to compete, thus far none have been able to.

We continue to advise cautious accumulation of long positions. [February 28, 2006]

Chart 6 – May cocoa



*Courtesy Reuters*

## **CORN**

### **Uncertainty about supply, but demand takes off**

Early – very early – projections for the 2006-07 marketing year for corn reflect many of the developments that we've been discussing over the past several months. At its outlook conference earlier this month, the USDA forecast that US farmers will plant 80.5 million corn acres, down substantially from 2005-06 plantings of 81.8 million acres. Assuming normal weather and yields similar to 2005-06, the US would produce 10.81 billion bushels, or 3% less than 2005-06.

The primary premise for smaller acreage is – or was – the cost of natural-gas based, or nitrogen, fertilizer. Natural gas prices soared about 250% in 2005 (Chart 7). Corn uses more nitrogen fertilizer than any of the other major US crops, and skyrocketing prices cut profit potential for corn farming dramatically. Soaring natural gas prices left nitrogen fertilizer production unprofitable, which forced a significant percentage of factories to shut permanently, which of course contributed to tighter supplies of fertilizer and inevitably higher prices.

It was a fairly airtight bullish case for corn prices in the making. Where the choice exists, planting soybeans looked to be a better idea. The early USDA estimate for soybean plantings was 74 million acres, up from 72.1 million acres for the 2004-05 season.

Natural gas prices, however, have collapsed all the way back to the January 2005 low. Is the bullish effect of high fer-

tilizer on corn acreage gone? There are a number of factors to consider. For example, even if the factories that closed down were to reopen, it probably wouldn't happen before the planting season, and supplies are likely to remain tight in the immediate future.

We posed the question to a USDA feed-grain analyst, and it seems that there is some flexibility at this point to switch crops, but not all that much. Our best guess is that natural gas prices have been falling for months now, which was probably enough time to pull some acres back to corn. In any case, we'll get a better idea on March 31, when the USDA releases its planting intentions report.

Regardless, the corn market is at the beginning of what we believe will be a long-term demand-based bull market.

Skeptics about the commercial viability of ethanol usage abound, but there is a revolution taking place. At its outlook conference, the USDA said that corn-based ethanol production in the US will increase by 34% during the 2006-07 marketing year, to 2.15 billion bushels. This means that the percentage of the crop used for fuel will jump to 20% from 14% this past season.

Were it not for recent export activity, this might not be such a startling development. Early this season the USDA forecast an improved year for US exports. When weekly export commitments did not support this, the estimates

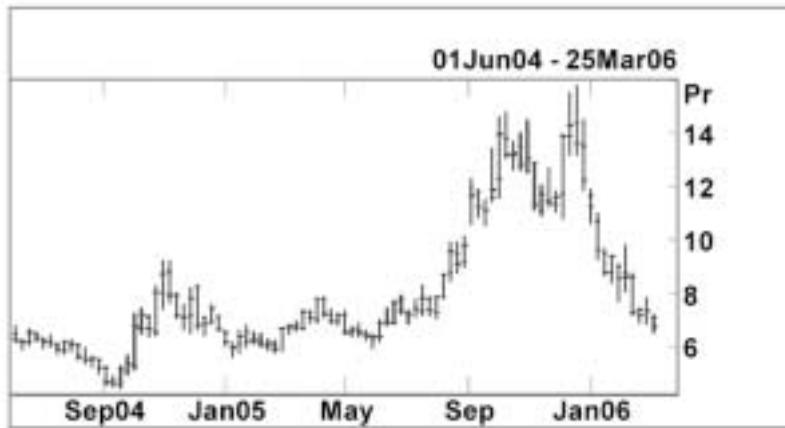
started falling. Now the USDA has fallen significantly behind. In February the downwardly-revised January estimate of 47 million tonnes was maintained. Over the past six weeks, however, new sales have gained relentlessly, averaging more than 1.5 million tonnes. Total commitments of 31.66 million tonnes are 10% out in front of last year at this time, while the USDA estimate represents a gain of only 2%.

Total shipments, which become more important as the marketing year wears on and which were lagging last year's pace as recently as early February, have sprinted ahead of last year by 3% as well.

In conclusion, in light of the plunge in natural gas prices, the bullish case on the supply side definitely has to be downgraded a notch. The demand side, however, compensates fully with the rather surprising estimate for 2006-07 ethanol output and the vigorous exports we've seen.

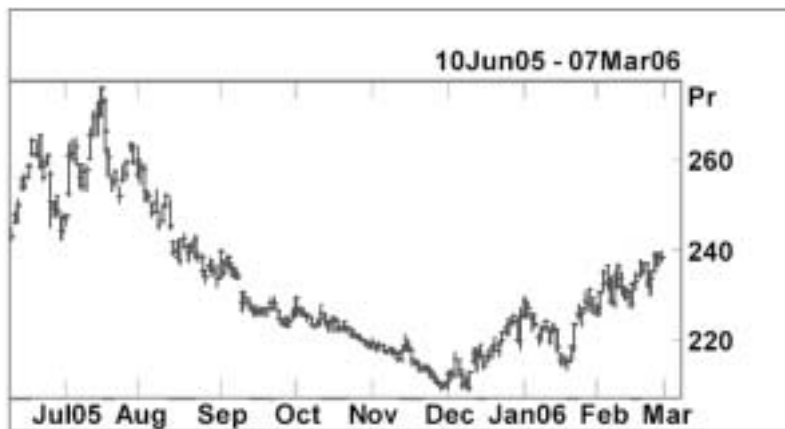
Commodity funds have taken a strong interest in the long side. They've gone from a flat position just a few weeks ago to 150,000-contract net-long position. Open interest has soared to dizzying heights of over 1 million contracts, a record by far. Expect volatility to increase, and use pullbacks to establish long positions. [March 1, 2006]

Chart 7 – Weekly natural gas



Courtesy Reuters

Chart 8 – May corn



Courtesy Reuters

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