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FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.



Volume 10, No. 2 March 7, 2007

Corn: are we really using that much ethanol?

The January USDA supply/demand report contained a *bona fide* surprise for traders. The final estimate for the crop harvested the previous fall was revised to 10.535 billion bushels (BB), or (267.60 million tonnes (MT), down sharply from the 10.745 BB (272.93 MT) December estimate. Perhaps more significantly, though, the revision was well below the low end of the range of analysts' guesstimates of 10.64 BB (270.37 MT).

March corn responded in classic fashion, with a 20¢-per-bushel limit-up opening that held right through to the close. We don't see that very often. The market tacked on an additional 25¢ per bushel over the next few sessions, but prices then drifted back, and the market went into the February situation report with virtually no price progress emanating from what should have been a very bullish January report.

The February report caused a bit of a stir. Analysts were expecting a further reduction in US ending stocks, but they came in virtually unchanged from January, at 752 million bushels (19.1 MT) against the average guesstimate for a small increase to 766 million bushels (19.46 MT). The market has now climbed back and is attempting to make fresh contract highs (Chart 1).

Traders have a habit of initially focusing strictly on the US data, while sometimes ignoring what could be significant developments on the global scene. The US is the largest grower and exporter of corn. Argentina is the second largest exporter, but its foreign sales have been dwarfed by US sales over the years, so its output has not always drawn much attention. Not that it was a complete shock, but the USDA raised South American corn production in this report. The Argentinean estimate was increased by 2 MT, to 21 MT, while the forecast for Brazil moved up by 4 MT, to 46 MT. It would be record output for both countries.

The USDA raised its estimate for global consumption by 3.2 MT, which offset a good part of the 5.2 MT increase in the estimate for production. The estimate for ending stocks will increase to 12.06% of consumption, up slightly from the January estimate of 11.9%, but will still be the lowest inventory level in 35 years.

On January 10, a USDA economist made a presentation to a US Senate agriculture committee in which he conveyed a USDA forecast that US ethanol consumption growth would be explosive down the road. The economist forecasted,

that in 2007-08, consumption would jump by the corn equivalent of 1 BB, to 3.15 BB. This announcement attracted a fair bit of attention. The USDA confirmed this projection for 2007-08 usage at the annual "Baseline" conference held on February 14.

The forecast for such low ending stocks is predicated on the ability of US ethanol consumption to stay at usage levels forecast by the USDA. As such, there could be some trouble in ethanol paradise. Earlier this month, well-known commodity trader John Bondurant pointed out in a memo to clients that we may have been a bit over-exuberant about the development of the ethanol demand side. On February 2 the Energy Information Administration (EIA) reported that November ethanol usage was 163 million bushels corn equivalent, up 24.4% from November 2005. For the first three months of the corn marketing year, usage is up 25.3%. The problem is that the USDA estimated US consumption to be 35% higher than the previous marketing year.

If ethanol usage is indeed growing at only 25% per annum in the US, we would have to add about 150 million bushels (3.81 MT) to US ending stocks. After plugging the lower consumption level into the global balance sheet, ending stocks as a percentage of consumption would jump to 12.5%, still a very bullish number in historical terms, but in all likelihood, not the kind of number that is going to keep prices at the \$4-per-bushel level.

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The USDA keeps raising the estimate for US exports based on very strong weekly commitment data. The most recent revision brings annual sales up to 57.15 MT, up 1.25 MT from the January estimate. Both commitment and shipments data are comfortably in line to meet these estimates. There are still over six months left in the marketing year, however, and the export pace must be maintained.

No evidence exists to suggest that sticker shock or any other issue will prevent foreign sales from continuing at their current pace, but the slowdown in ethanol consumption should send a shiver down the backs of bulls. If next month's EIA data don't show an uptick in usage, we may be looking at somewhat of a trend.

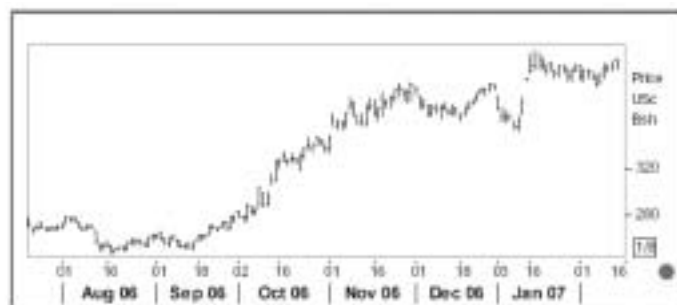
The massive increase in US acreage for the 2007-08 season is well known and will not be a bearish factor unless estimates turn out to be on the low side. The extent of South American corn-acreage expansion, however, is not

known. With the ability to lock in new crop prices at levels not seen in over a decade, it is quite reasonable to speculate that Brazilian and Argentinean farmers might advance corn acreage the way they did soybean acreage earlier this decade.

The main issue in the short term, which the market seems not to have spent much energy on – yet – is the possibility that US ending stocks have been understated by a wide margin because of overstated ethanol consumption. Were this to be the case, we believe that the backwardation in old-crop/new-crop spreads is not sustainable (Chart 2).

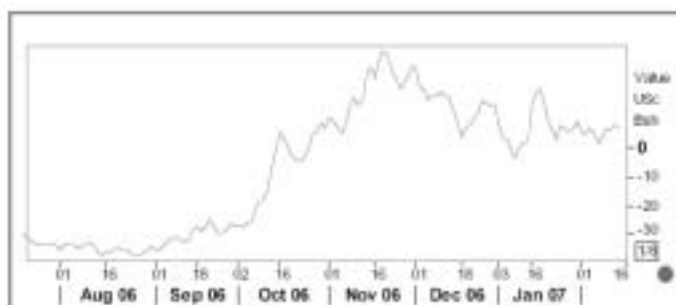
We're going to take the rather bold view that this market has run out of steam, for the moment anyway. We're not so bold as to be outright short, but selling the old-crop/new-crop spread is a more conservative approach. Sell May/buy December corn. Initially, use the high in the spread – 35¢ per bushel – as a stop. *[February 15, 2007]*

Chart 1 – March corn



Courtesy Reuters

Chart 2 – May/December corn spread



Courtesy Reuters

SUGAR

Fundamentals remain as bearish as ever

On March 2 the sugar market completed (we think) a short-covering rally that took the market 12% off lows set in early February. Our theory is that commodity funds – which have obviously been short – struggled in their efforts to roll over their March positions to May and extended their capitulation past the last trading day for March. To illustrate, consider that the March/May spread swung from a contango of 20 ticks in early February (Chart 3) to a backwardation that reached 75 ticks on February 28, the final day of trading for the March contract. May/July was dragged along as well, but fluctuated only between a flat spread and backwardation of 20 ticks, and has now settled back to the mid-point of its recent range (Chart 4). Furthermore, the rally ended with a bang. A two-day, 80-tick run ended with a poor close and a gap-lower opening below the low of the previous session, a classic bull trap, island reversal (Chart 5).

Crude oil has rallied \$10 per barrel off its lows, and it's tempting to start drawing the energy connection back to crops that are convertible into bio-fuels such as sugar, corn,

and soybean oil. Indeed, the amount of these commodities that is used for energy continues to tip the balance of the food-fuel ratio in favor of the fuel side. The more immediate future, however, is dominated by shorter-term supply/demand fundamentals, and those have not changed very much – if at all.

In the case of sugar, the primary market mover has been, and continues to be, the quick response by sugar producing nations to prices they have not seen since the 1970s. Even after the steep slide in prices we experienced in 2006, sugar farming is still more profitable than it has been at any time over the past 10 years. There have been no crop failures, and the market is amply supplied.

Checking the world's important sugar growers, we find that estimates for India – the world's second largest grower after Brazil – have crept upwards over the past few months. A government official recently said that the 2006-07 crop year, which ends in September, should produce between 24 and 25 million tonnes, compared with 19 million tonnes the

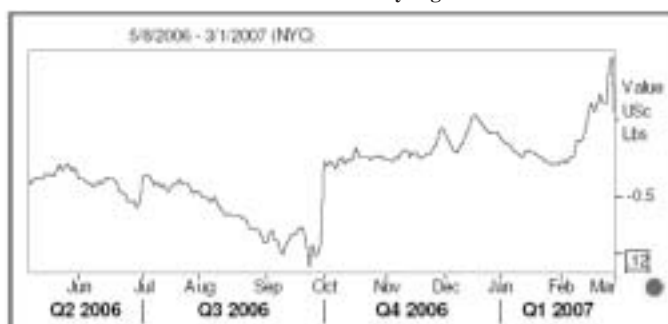
previous season. On January 11 the Indian government completely abolished all regulations that have restricted exports in the past, and it is expected to sell up to 3 million tonnes this marketing year.

In Brazil, the 2006-07 marketing year is winding to a close and estimates are as high as 30.8 million tonnes, up from 26.8 million tonnes last year. Industry estimates for the 2007-08 crop, which is now entering the harvest season, could be 10% higher than 2006-07 based on planted area, and as much as 13% larger with ideal weather conditions.

All the major sugar analysts, such as the International Sugar Organization, F.O. Licht, and Czarnikow, continue to revise their estimates for the 2006-07 surplus upwards, with the range of forecasts now at between 6 and 7 million tonnes. Licht estimates that ending stocks will be 48.8% of consumption, up from 43.9% at the end of 2005-06.

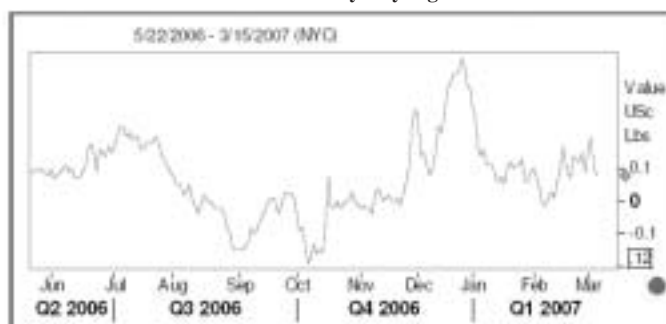
We were spooked by the rally and regrettably advised trading clients to cover short positions. We recommend reentering of the short side and until further notice maintaining our original stop at 13¢ per pound, basis the front month contract. [March 7, 2007]

Chart 3 – March/May sugar



Courtesy Reuters

Chart 4 – May/July sugar



Courtesy Reuters

Chart 5 – May sugar



Courtesy Reuters

SOYBEANS

South American soybean output at a record, but corn steals massive acreage in the US

After a solid bull run that saw soybean prices reach levels not seen since 2004, the market has set back somewhat. Until now we argued that strength in the soybean market was tied to the powerful bull market in corn. We've lost our bullish enthusiasm for corn (at least temporarily, see *Focus on Futures*, February 15). Soybean prices should follow suit. Or should they?

On paper, soybeans have no business trading close to \$8 per bushel. The USDA's February estimate for 2006-07

global ending stocks was revised upwards, to 57.43 million tonnes, or a record 25.8% of consumption, up from 24.5% in 2005-06 and 23.5% in 2004-05.

South American production is poised to set another record. The estimate for Brazil has been steady at 56 million tonnes for several months now. Heavy rainfall in the late stages of the growing season and Asian rust may have trimmed close to 1 million tonnes off the crop according to a March 6 report by analyst *Oil World*. But Argentinean output

continues full steam ahead with a 1.5-million-tonne upward revision by the USDA in February to 44 million tonnes.

South American supply has been the primary bearish factor, and for now, particularly since the crops are now being harvested and becoming available, there could be downward pressure on the market. The other major areas of this market, however, have been tilting towards the bullish side.

The big one is 2007-08 US soy acreage. Planting has already begun in some regions, and a significant chunk of acreage is being shifted to corn, because corn prices have skyrocketed *vis à vis* soybean prices (Chart 6), making corn farming more profitable. The early USDA forecast released at its Outlook Forum on March 1 and 2 put soy acreage at 70.5 million acres, down from 75.5 million acres planted in 2006-07. Private forecasters who conduct their own surveys have weighed in with much lower acreage estimates. Allendale, for example, released an estimate on March 2 calling for 65.9 million acres. With trendline yield of about 43 bushels per acre, that would translate into scant crop of 76.4 million tonnes, compared with 86.77 million tonnes in 2006-07. Even if demand were to stagnate, we would be looking at a drawdown in global inventories. The most recent instance of a drawdown of global inventories resulted in the run to \$10.5 per bushel in 2004 (Chart 7).

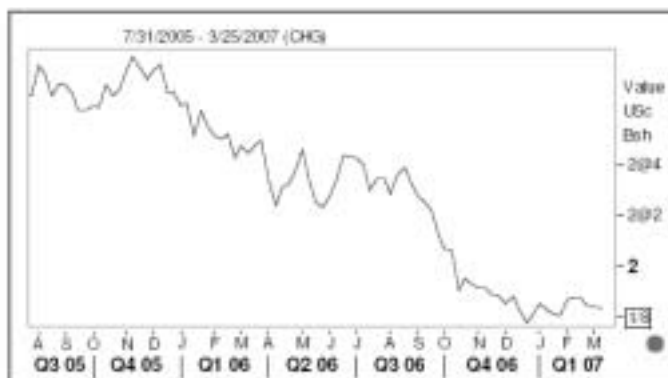
How does demand look? In February the USDA lowered

its estimate for 2006-07 US exports by 500,000 tonnes, to 29.94 million tonnes, which is still up from 25.78 million tonnes in 2005-06. This was probably in anticipation of the South American harvest going into full swing, but it was certainly not because of any let-up in US sales. Commitments are running at 83.8% of the final estimate, while last year at this time they were only at 76%. Shipments stand at 66% of the USDA estimate for final sales, compared with last year at this time when US exporters had shipped only 62.8% of final sales.

The budding bio-diesel market will play an increasingly larger role in this market. It will serve to keep crush margins strong in periods when feed demand softens, which could in turn tighten bean supplies. Usage of bio-diesel has not matured at the same pace as the corn-based ethanol market. Still, *Oil World* said in a March 6 report that world trade of the four major vegetable oils grew 35% in 2006 because of the energy-demand component of the market.

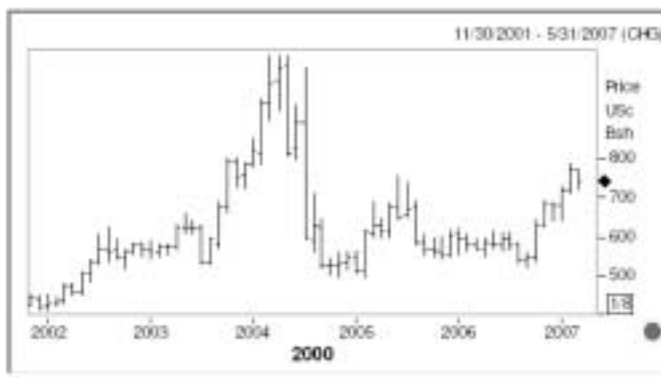
In any case, these developments are not going to drive us to the long side just yet, but it does change the tone of the attitude that we have had towards this market in recent months as nothing but a drag-along to corn. With such a wide range of expectations for US acreage, and the possibility of a much smaller US crop this coming fall, it will certainly keep us away from any ideas of taking a short position. Remain side-lined, but stay tuned. [March 8, 2007]

Chart 6 – Soy/corn ratio



Courtesy Reuters

Chart 7 – Nearest contract soy



Courtesy Reuters

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