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Copper prices snap back even as surplus grows

The bull run in copper that began in late-2008 suffered its largest setback in January, with a whopping 73¢-per-pound, or 20%, trouncing. The market bounced off the \$2.80-per-pound level and has since recouped over half the losses. Chart 1 illustrates fairly clearly that copper prices moved in lock-step with the stock market – for both the selloff and the subsequent recovery.

The US economy has emerged from recession – at least officially – with two quarters of positive GDP. Despite this, the bull run in stocks came to an abrupt halt in mid-January, when financial-market participants shifted their attention to Eurozone problems. The fear of default among weaker members and the potential fallout from the contagion that would result sparked a correction in the stock market that saw the DJIA drop 8.3% of its value. Commodity prices – and in particular industrial commodities – followed the lead of stocks.

In analyzing copper independent of the influence the broader markets have on it and other commodities, we will find that developments in the supply/demand fundamentals continue to be bearish.

Chilean output grew a modest 0.8% in 2009, to 5.4 million tonnes, but that statistic doesn't tell the whole story. Average monthly production from January through July was down 4.85%. From August through December, average monthly production was up 7.62%, which is far more representative of the current trend. Early estimates for future production are for increases of 5.5% and 3.5% for 2010 and 2011, respectively.

We should continue to anticipate ample supplies, not only as a result of strong Chilean output, but from production in South America, Africa, and Asia, as well. Production costs are generally so far below current price levels that the economic viability of investment in new infrastructure is excellent. In a report released earlier this month, the International Copper Study Group (ICSG) estimated that global mine capacity will grow by 4.35% per annum over the next several years.

Chinese imports drove this market even while the rest of the world was struggling through its economic woes. However, the dynamics that required huge monthly purchases of copper

from abroad have changed. Even a limited response by the economy to the restrictive monetary measures instituted recently by the government should manifest to some degree in slowing demand for industrial commodities.

In addition, Chinese mine production was up 10.8% in 2009, to 1.039 million tonnes. Total Chinese mine output is still only 20% of Chilean output, but for every additional 100,000 tonnes that is mined locally, a similar amount comes off the import book. Chinese customs data show that monthly imports are already well below the extraordinary mid-2009 levels (Chart 2).

Global warehouse stocks continue to climb (Chart 3).

ICSG's most recent monthly report, which covers the period between January and October 2009, shows that the global balance sheet has sprinted into a surplus position of 78,000 tonnes. That's up from the previous month, when the market was still in a *deficit* of 52,000 tonnes. Several months ago, ICSG forecast that 2009 would end with a surplus of 370,000 tonnes. At the time the market was still in deficit and that estimate seemed unattainable. With the large monthly supply increases we've been seeing, the forecast for a large surplus seems far more realistic.

Having presented a very clearly defined bearish case, traders are by now keenly aware that copper prices are inex-

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

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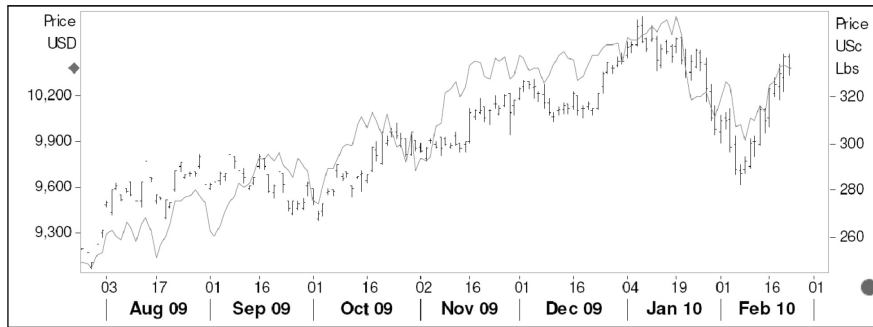
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orably tied to the fortunes of the stock market. For now. In theory this is quite a logical relationship. We believe, however, that any increase in demand that is generated by improving economic conditions will ultimately be overwhelmed by the incentive to overproduce.

We advise maintaining positions in bear spreads, but at this point, we feel comfortable recommending an outright short position in May copper, as well. Use the \$3.55-per-pound high as a stop, close only.

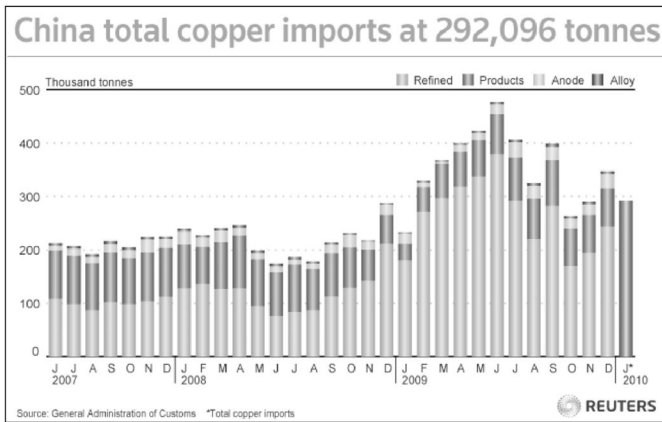
[February 19, 2010]

Chart 1 – May copper (bar), DJIA (line)



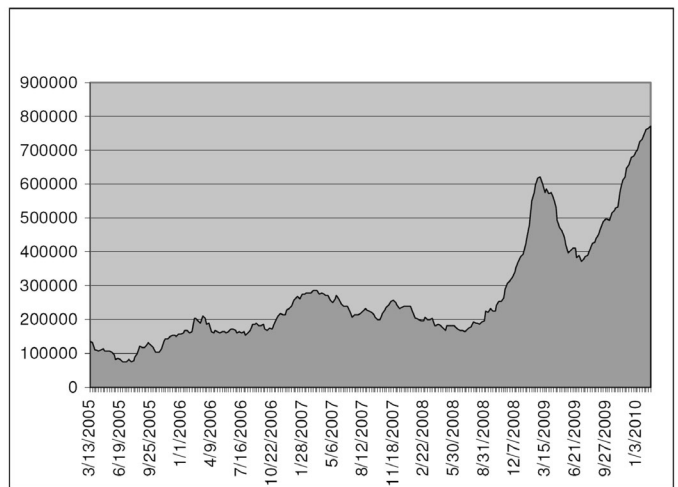
Courtesy Reuters

Chart 2 – Chinese copper imports



Courtesy Reuters

Chart 3 – Global warehouse stocks



Courtesy Reuters

SOYBEANS

Beans galore

The USDA estimate for 2009-10 US soybean exports has been revised upwards every month since the marketing year began in September. This month was no exception, and although it may not be the last, the rate of increase will start coming down sharply.

In the February supply/demand situation report, the forecast for final sales was raised to 38.10 million tonnes, up 680,000 tonnes from January, and up from the 34.84-million-tonne September estimate. Commitments stand at 35.5 million tonnes, and with six months remaining in the mar-

keting year, exporters would have to sell an average of only 100,000 tonnes per week to meet the USDA estimate.

The torrid pace of overseas sales, however, has all but ground to a halt. Average weekly commitments of old-crop beans over the past four weeks has fallen to 392,000 tonnes, down from the previous four-week period of 802,000 tonnes, which was down from 945,000 tonnes in the four-week period prior to that. While even a meager flow of commitments would mean further upward revisions to the final-sales estimate, it would appear that the Chinese are satiated with

beans at the moment, and we cannot rule out the possibility of cancellations. It's happened before, particularly in an environment in which the Chinese government has decided to restrict credit to cool down the economy.

US domestic usage continues to normalize from recessionary levels and mitigate the losses on the US export book. The most recent NOPA data show that the January crush was 162 million bushels, slightly below December, but still significantly above 139 million bushels crushed in January 2009.

The strength of the domestic crush, however, is dependent on soymeal exports. The surge in the domestic crush over the past few months is not sustainable if foreign sales of meal begin to dry up. Over the past four weeks, meal commitments averaged only 183,000 tonnes, compared with a weekly average of 280,000 tonnes in the previous four-week period.

The February estimate for 2009-10 US ending stocks fell to 5.7 million tonnes, down from the January estimate of 6.67 million tonnes. Certainly, on the surface, it looks like "here we go again," with only a small improvement in the carryover to 6.3% of consumption, up from last year's 4.5%. But as we near "making the crop" in South America, everything has changed. South America can now carry the market through after US beans have run out. That shift was delayed for one year because of last year's Argentinean drought, but has now arrived.

The USDA raised the estimate for Brazilian output in its

February report by 1 million tonnes, to 66 million tonnes. Some private estimates are even higher. When combined with Argentinean output, that's 119 million tonnes, up from last year's drought-reduced 89 million tonnes, and above 2007-08 output of 107 million tonnes.

Global ending stocks for 2009-10 are estimated at 25% of usage, up from 18.7% last season, and back to pre-bull-market territory.

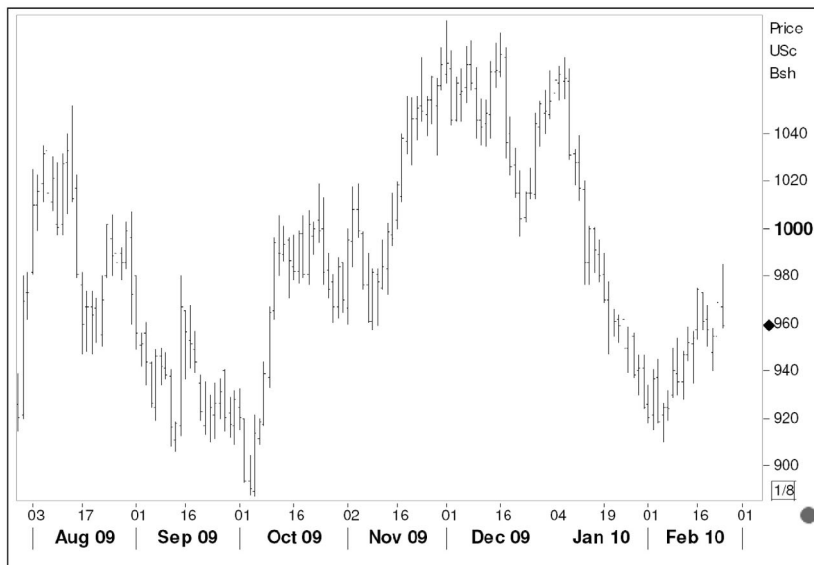
This week, excessive rains hit parts of Argentina, and the markets rallied because of fears of yield loss and delayed harvests. The concern was actually more for corn than for beans, but the beans participated regardless. Then traders shifted their attention north, to excessive rains in the US Midwest, which threatens to delay planting.

Early forecasts for US acreage for the upcoming 2010-11 crop are in. The USDA-Forum estimate is 77 million acres, down 500,000 acres from last year. But all major analysts have higher estimates, with some estimates at over 79 million acres. Many acres in the North were never planted last year because of flooding and are likely to be put back into production.

We find the balance of evidence to be bearish. With South American availability trickling in at first, and soon enough flooding the market, we believe these price levels will not hold for long.

Sell short May soybeans, using an initial stop of \$9.85 per bushel, close only. *[February 24, 2010]*

Chart 4 – May soybeans



Courtesy Reuters

WHEAT

Going nowhere

There's been one extraordinary event in the wheat market over the past few months, and the market's reaction to it was equally extraordinary, in counterintuitive fashion. Analysts were well aware that cheaper, abundant, global alternatives presented stiff competition for US wheat farmers, and that as a result, winter wheat acreage planted in the autumn of 2009, to be harvested for the 2010-11 marketing year, would be down from the previous season. Winter wheat acreage for 2009-10 was 42.098 million acres. The average of analysts' guesstimates for 2010-11 was 40.501 million acres, but the January 12 USDA forecast came in at a scant 37.097 million acres.

That would be the smallest area planted for the US winter wheat crop in modern history. There have been five instances since 1965 in which the final area was 1 million acres larger than the initial January forecast, but the average variance during that period is statistically insignificant. And even if the estimate were to grow by 1 million acres, it would still be the smallest area in modern history. You would have to go back to the early 1970s to find such small winter wheat crops.

So that's extraordinary. What was arguably more astonishing is that the market yawned and could not even muster a one-day rally during the session following the release of the data. New-crop December proceeded to drop sharply, falling \$1 per bushel in the weeks to follow, finally finding some support in early February (Chart 5).

The US is not alone. Preliminary estimates put 2010-11 global wheat output at about 650 million tonnes, down 4% from the record produced in 2009-10.

The market's weakness is no great mystery – current supplies are deemed abundant and sufficient to carry the world through any tightness that might normally result from a sharp drop in output.

To illustrate, consider India, for example. We never hear much about the Indian wheat market, because it has been self sufficient for many years, neither importing or exporting. The

USDA estimate for 2009-10 output is 80.50 million tonnes, but recent estimates have put production as high 82 million tonnes. This compares with 78.5 million tonnes in 2008-09 and 75.9 million tonnes in 2007-08. Domestic consumption has been on the rise, but is still only 76 million tonnes. As a result of this season's bumper crop, the country is left with burdensome inventories – a problem that must be dealt with because of a shortage of storage space. February 1 stocks stood at 22 million tonnes, up from 18 million tonnes a year earlier. India has restrictive export rules that ensure it remains self sufficient, but government representatives have already indicated that the rules will be relaxed to accommodate exports. Analysts say that India will sell 3 million tonnes this marketing year.

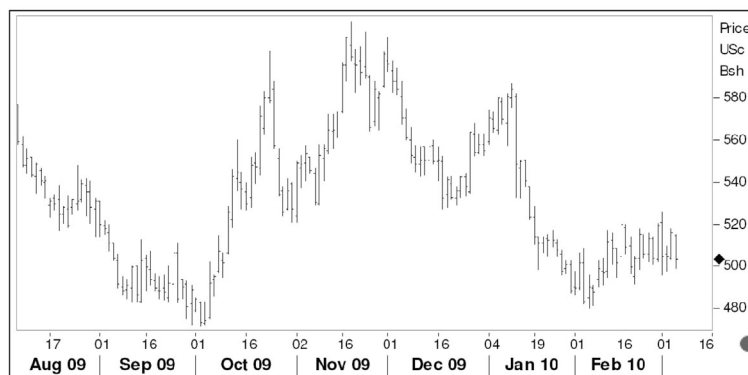
The 2009-10 marketing year will end with global carry-over stocks of 196 million tonnes, or 30% of usage, the highest level since 2001-02.

While it would appear that this market is a ripe candidate for a short position, we are going to maintain a neutral trading stance. The market certainly responded to high prices by producing record crops. Chart 6 includes the projection for a smaller global crop in 2010-11. If the forecasts are accurate, we would be looking at a balanced or near-balanced market, even if there is some continuation of demand growth. But with so much of the world's wheat supply coming from the Northern Hemisphere winter wheat crop, no new supply can be generated for a full year. The market is left vulnerable to unanticipated weather or a jump in demand.

On the other hand, there is so much supply in the pipeline that even bullish supply/demand factors are unlikely to spark a sustainable bull run.

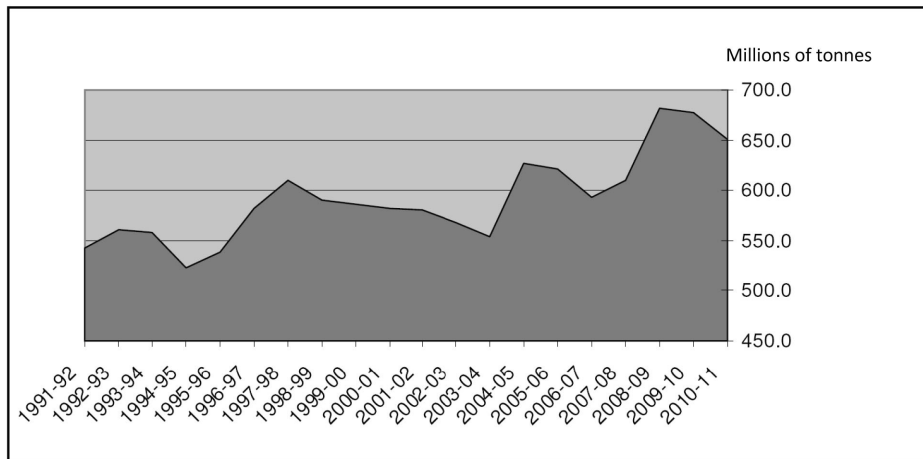
We expect the market to slosh around in the \$4.5 to \$5.5-per-bushel range with no clear trend. Aggressive and well-capitalized traders might consider option strategies such as selling straddles that would take advantage of a range-bound market. [March 5, 2010]

Chart 5 – May wheat



Courtesy Reuters

Chart 6 – Global wheat production



SUGAR

Is it over?

Should have known. Just around the time the well regarded sugar analysts were raising their estimates for the 2009-10 global sugar deficit rather liberally – in increments of millions of tonnes – the sugar market was embarking on what (thus far) has turned into a 25% correction. Bear market?

The answer is that we're not certain. Maybe. While we concur that the arithmetic was accurate in estimating a deficit of between 10 million and 15 million tonnes, the latest deficit forecasts have not accounted for some recent developments, which, to be sure, were definitely bearish. Several million tonnes of sugar unexpectedly appeared on the market.

The EU completed granting export licences for 500,000 tonnes of out-of-WTO-quota sugar. This news was old, but now the sugar is actually going to hit the market.

Yields in one key Indian region, Uttar Pradesh, turned out to be much higher than expected. Output for 2009-10 is now estimated at 16 million tonnes, up from the long-standing 14.5-million-tonne estimate. A similar better-than-expected cane recovery has been reported in Brazil, although not nearly as dramatic as the additional 1.5 million tonnes India will produce.

Officially, Indian domestic consumption is still listed at 23 million tonnes for 2009-10, but the government has pushed ahead with its plan to curb demand. Large buyers are expected to maintain only 10 days' worth of inventory, which means that after the supply is exhausted, their customers will simply not consume sugar.

The new supply still leaves a deficit of several million tonnes for 2009-10, but a far more manageable one. This is particularly true as traders begin to look ahead to the new 2010-11 crops, which are expected to be huge.

Brazil will begin to harvest its new crop soon, and early estimates are calling for output of a-record-by-far 37 million tonnes. That will be about 20% larger than 2009-10 production. Ethanol production is expected to garner a larger portion of the cane crop – 58% vs 56.8% in 2009-10 – but there seems to be plenty to go around for both the food and fuel industries.

Early forecasts for 2010-11 Indian output are calling for a return to normal production of 23 million tonnes. In addition, no doubt, many sugar-producing nations have taken advantage of these astronomical prices to maximize available sugar acreage.

That's the bearish case, and it's a solid one. However, there are unresolved issues. We rarely discuss the US sugar market, because it's been fairly well balanced over the years – the absurd subsidy system notwithstanding. There is a shortage developing, though, and imports of 3.3 million tonnes will be required for the 2010-11 marketing year. That's up from 2 million tonnes in 2009-10. Mexico, a traditional supplier, will not be much help, because it had a poor crop and may even import sugar for its domestic needs.

China imported about 1 million tonnes of sugar in 2009. It's difficult to understand how Chinese imports are

not growing. Domestic consumption is around 14 million tonnes. This past season, production was 12.5 million tonnes, but 2010-11 output is expected to fall to 11 million tonnes. The government has been releasing large amounts from inventory for sale, but the stockpile is not likely to be inexhaustible. This is the largest deficit we've seen. We haven't heard from China yet, but we're guessing that it's inevitable.

In citing the examples of the US and China, we find that the demand side seems to have remained generally strong, save for the rationing in India. The upcoming crops are the principal issue.

A loose calculation that encompasses a smaller deficit for 2009-10 and larger 2010-11 crops shows a balanced market or a small surplus for 2010-11.

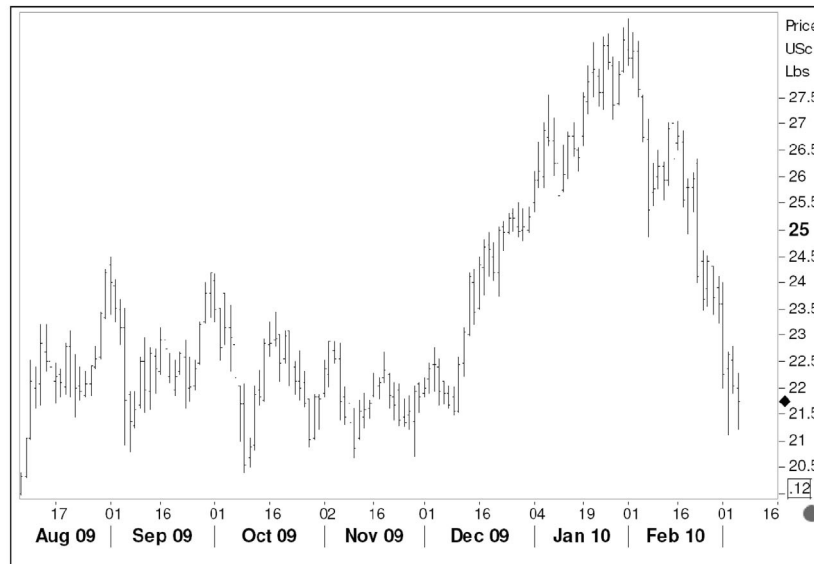
We did not see this slide in prices coming, certainly not to such a magnitude. The Commitment of Trader data show the funds still maintain a large net-long position. A good chunk of the selling took place over the past 10 days, and it's hard to believe that we haven't stopped out many more longs.

It's been a classic bull market. Producing nations are responding by ramping up output. With good weather, the bull market may be over. On the other hand, bringing the market into balance will require enormous output growth. Demand has not shown any weakness.

We've held on to our long positions, and having come this far in the liquidation phase, we recommend placing sell stops at 20.50, basis May close only.

[March 5, 2010]

Chart 7 – May Sugar



Courtesy Reuters

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