FRIEDBERG'S

FOCUS ON FUTURES

Friedberg Mercantile Group Ltd.

Volume 18, No. 2 March 4, 2015

Cocoa: Ivorian comeback

There have been important developments in the cocoa market on both the supply and demand sides.

On the supply side:

When we last wrote about cocoa (see *Focus on Futures*, January 7), we noted that dry weather during the main-crop growing season in the Ivory Coast had year-to-date port arrivals down sharply from the previous season. At that time, arrivals were 14% below year-ago levels. The massive 1.7-million-tonne crop that Ivory Coast farmers grew in 2013-14 would be a one-time event, or so it seemed, and 2014-15 output would return to normal levels of 1.4 to 1.5 million tonnes.

Not so. As of February 10, exporters report that arrivals reached 1.141 million tonnes, and have overtaken last year's 1.116-million-tonne tally at this point of the season. There is no guarantee at this time that arrivals will continue to keep pace. The tail end of the main-crop and the entire mid-crop are still wild cards. It is fair to say, however, that as weather scares go, this one has not materialized in the gloomy fashion forecast only one month ago. Some analysts are now predicting that Ivorian output will reach 2013-14 levels.

Ghana, the other key West African producing nation, has also seen a sharp drop in this season's output. However, up-to-date information on the progress of Ghana's crop is scarce. As in the case of the Ivory Coast, we suspect that improved weather has not yet been reflected in forecasts.

On the demand side:

Fourth-quarter grind statistics for all regions were dismal. The European grind was down 1.1%. For North America, cocoa processing fell 1.95%, the first quarterly year-over-year drop in two years.

As Asian producing countries, such as Malaysia and Indonesia, expand processing facilities, analysts have tended to excuse weak European and North American results on a slow shift to Asian grinding. No luck here either. Fourth-quarter Asian grinding was down 17.2%.

Asian butter ratios have recently been quoted as low as 1.95 times the London spot price. That's down from 2.15 in December and considerably below mid-year values that reached over 2.5. With product prices falling, the incentive to buy beans for processing is diminished and the burdensome global stockpile continues to grow.

The market has been in backwardation, which is somewhat puzzling. Most recently, the one-year forward spread collapsed as prices dropped during January, then bounced again with the early-February rally. With the extreme volatility in these spreads, we do not find the implications nearly as menacing as they were when the backwardation was climbing steadily (Chart 2).

As improved output data and slumping grind results are streaming in, some forecasts for the 2014-15 global production/consumption balance have been revised to reflect the bearish fundamentals and are now calling for a surplus that could reach as high as 150,000 tonnes. So where's the bullish case?

Remain short. Maintain stops at $3,100 per tonne, basis May, close only. *[By Sholom Sanik, February 11, 2015]*

Inside

Cotton: Bear's last gasp? 2
Sugar: Bear still feasting 4
Wheat: Properly priced? 5

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

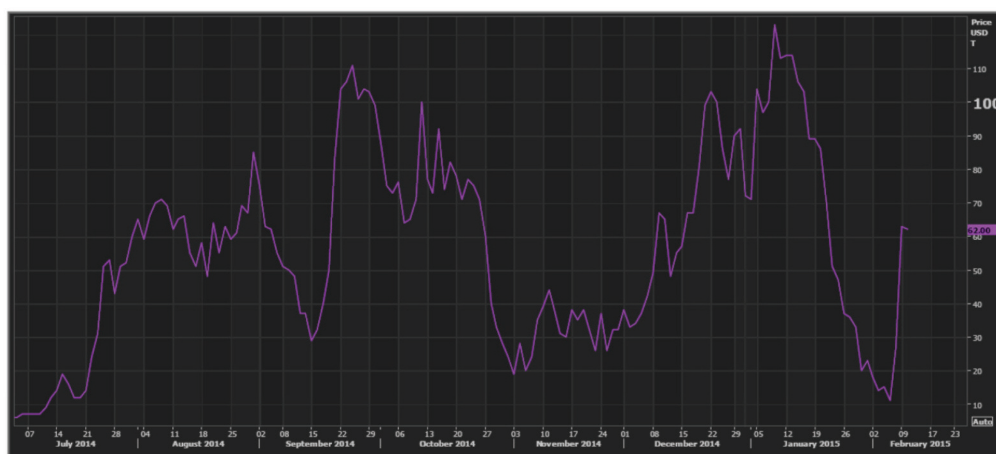
Get Focus by e-mail
Focus on Futures is available by e-mail as an Adobe PDF file. If you prefer to receive your copy of *Focus on Futures* by e-mail, please send us a message at *focus@friedberg.ca* with your full name, e-mail address, and street address.

©2015 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

Chart 1 – May cocoa

Courtesy Bloomberg LP

Chart 2 – March 2015/March 2016 cocoa spread



Courtesy Bloomberg LP

COTTON

Last gasp for the bear?

Cotton prices have been confined to a range of 58¢ to 63¢ per pound since the 2014-15 Northern Hemisphere harvest began (Chart 3). Massive global inventories continue to edge upwards. The February USDA crop report puts ending stocks at 109.84 million bales, an astounding 98.7% of usage.

The implications of these huge stocks may be more complicated than would appear at first glance. Chinese stocks represent 59% of the buildup, and yet the Chinese have not been absent from the import market. Policies announced last year, intended to whittle down the stockpile, should have all but ground imports to a halt, but that has not been the case.

In a little-noticed revision in the USDA crop report, Chinese imports were revised upwards, by 300,000 bales, to 7.3 million bales. Albeit a tiny change in the grand scheme – last year China imported 14 million bales – there may be more to come. US sales to China this marketing year stand at 2.2 million bales, compared with 1.8 million bales at this time last year.

Aside from Chinese purchases, world trade has been much stronger than expected. Early in the marketing year, US exports were forecast to be about 1 million bales below 2013-14. As of the most recent weekly export report, commitments have moved out in front of last year by over 1 million bales. Over the past four weeks, commitments averaged 470,000 bales. We would have to go back to the 2006-07 season to find such a strong string of weekly exports at this point of the marketing year.

The USDA has responded to the brisk sales pace and

©2015 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

now forecasts annual sales just slightly larger than last year's. If the trend continues, we will see more aggressive revisions by the USDA in the coming months.

Early farmer surveys for the upcoming spring planting season indicate that US cotton acreage will fall sharply. The National Cotton Council estimates that acreage will fall 15% from 2014-15, to 9.4 million acres. For many regions in the US, production costs are higher than current prices, leaving farmers with little incentive to plant cotton. Other crops could offer greater profitability.

The estimate for lost acres could be a bit premature, though. The surveys were taken in mid-December when cotton prices were weaker than their counterparts. While new-crop cotton prices remain near their lows *vis-à-vis* corn, they have gained some ground on new-crop soybeans and wheat, which could change the economics of planting cotton, at least to some degree (Chart 4).

In any case, with average national production costs still below new-crop prices, we will almost surely see much smaller cotton area. The same will probably hold true for other major producing nations, such as China and India, although we have not seen any specific estimates to date.

In conclusion, normally, a market with solid demand and lower production forecasts would have traders looking for a bottom, particularly since prices have fallen so much. It is impossible, however, to ignore the (reportedly) overwhelming inventories held by China and other countries.

Remain short, as per our November 10 recommendation, but lower stops to 64¢ per pound, basis May, close only.

[By Sholom Sanik, February 12, 2015]

Chart 3 – May cotton

Courtesy Bloomberg LP

Chart 4 – Cotton ratios

Courtesy Bloomberg LP

©2015 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

SUGAR

The bear is still feasting on sugar

Cheaper gasoline at the pump was expected by many to have a negative impact on ethanol consumption. For the US, this certainly seems to be true. Weekly EIA reports show that ethanol stocks have been building and are at their highest levels since mid-2012 (Chart 5).

The USDA, however, does not believe that it is the beginning of a sustainable trend. In its February 12 monthly crop report, it actually revised its estimate for 2014-15 ethanol usage upwards by 75 million bushels to the corn equivalent of 5.25 billion bushels. In any case, most of the ethanol used in the US is consumed as the minimum 10% blend with petroleum, and lower prices at the pump have stimulated consumption. The burdensome stock situation should ease.

In Brazil, consumption above the mandated-blend level is discretionary and should therefore be far more elastic. Production is considerably more responsive to profitability, and in the course of the crushing season there is much greater volatility in the ethanol/sugar production ratio than we would ever see in the ethanol/corn output ratio in the US.

Nevertheless, the government is taking steps to halt the steep fall in sugar prices, and as a result, there are two mitigating factors. First, it raised taxes on fuel as part of a broader tax-hike program. The impact of falling crude prices will therefore have a limited effect on competitiveness with ethanol. Then, it increased the required minimum ethanol blend to 27.5% from 25%. The new mandate went into effect on February 15 and is expected to increase ethanol output by 1 billion litres, at the expense of sugar production. As a result of this move and dry weather earlier in the growing season, 2014-15 sugar production will remain flat at about 32 million tonnes.

The relationship between falling crude prices and the sugar market is not as cut and dried as the daily market commentaries would have us believe.

Meanwhile, 2014-15 Indian output is expected to jump by about 1.5 million tonnes, to 26 million tonnes. The government finally approved export subsidies for up to 1.4 million tonnes of raw sugar, which added to the bearish tone in the market and sparked a further selloff. Analysts caution, however, that the incentive for mills to actually take advantage of the subsidies is minimal because of low world prices and that we are not likely to see the exports materialize unless prices rise to over 15¢ per pound.

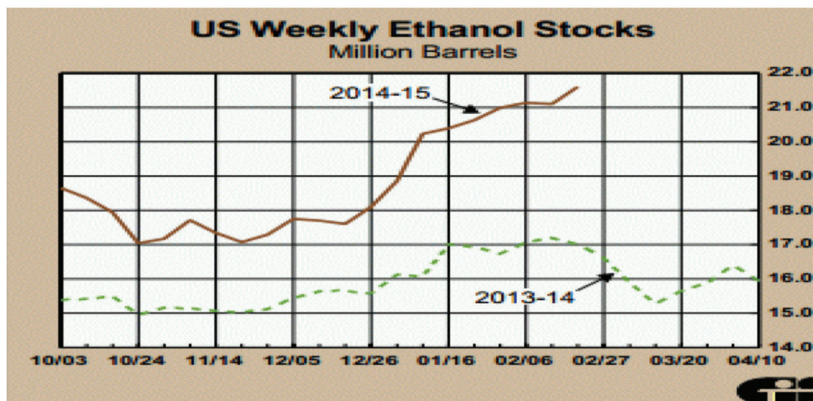
It is hard to tell from the way prices keep getting clobbered (Chart 6), but the 2014-15 marketing year will be the first year in many that will end with a production/consumption deficit. Although the deficit will be small – a few hundred thousand tonnes – some analysts are forecasting a much larger deficit for the upcoming marketing year. Platts Kingsman, for example, estimates that the deficit for 2015-16 will balloon to 5.2 million tonnes. Consumption is forecast to grow at the trendline pace of about 2%, but low prices will finally catch up with the market and see a decline of over more than 1%.

Sugar bulls occupy a lonely spot in the marketplace. All technical analytics point to an ongoing bear market with new lows around the corner. Commodity funds "hit the bids" on any rally. We still believe, however, that after years of losing money, mills in Brazil and India – particularly in Brazil – will continue to divert cane crushing to ethanol. It is just a matter of time before the market tightens.

Establishing a long position via futures, however, is like trying to catch a falling knife and is just asking for trouble. We therefore maintain our long-standing – but unfortunate – strategy of buying long-dated, slightly out-of-the-money call options. Buy and hold October 15¢-per-pound calls currently trading around 80 ticks.

[By Sholom Sanik, February 26, 2015]

Chart 5 – US ethanol stocks



©2015 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

Chart 6 – Weekly ICE sugar

Courtesy Bloomberg LP

WHEAT

Properly priced?

Earlier this marketing year, it seemed as though there would be steady demand for high-quality US wheat (see *Focus on Futures*, November 14). There were two issues among major exporters. Despite a large EU crop, poor weather was responsible for a higher-than-typical portion of feed-quality wheat. Second, the uncertainty surrounding the instability in Russia and the Ukraine had traders worried that exports would suffer. Ukrainian exports have been flowing, and although Russia has been enacting restrictions, the USDA maintains its 20-million-tonne estimate, which is still 1.5 million tonnes above last season's tally.

So as it turns out, the fears were exaggerated. With only three months remaining in the 2014-15 marketing year, US export commitments stand at 21.3 million tonnes, 7.3 million tonnes, or 24%, below last year at this time. While sales were expected to be lower, they are running substantially below the USDA estimate of only 21.3% less than 2013-14. Shipments are 27% behind last year's pace, so we can expect further downward revisions to the annual sales figure.

Global output for 2014-15 reached a record 725 million tonnes. Unlike other major crops, such as corn and soybeans, however, global inventories have not been restored to pre-bull-market levels. Ending stocks for corn have not been this large since 2004-05, and soybean stocks are at record highs. In contrast, wheat ending stocks are forecast at 27.7% of usage, still below the five-year average of 28.4%.

Looking ahead to the 2015-16 Northern Hemisphere winter wheat crop that was planted in the fall and will be harvested this spring, output is expected to drop. The USDA surprised traders with its forecast for a sharp reduction in US planted area. Analysts guesstimated that farmers would plant 42.564 million acres, slightly higher than 42.399 planted for the 2014-15 crop. The USDA estimate came in at 40.452 million acres.

European area is expected to expand by about 2%. All told, for winter and spring crops, early forecasts are calling for global output to fall by about 2%.

With lackluster demand, a strong dollar, and traditional exporting nations selling more wheat than they were expected to, prices should remain sluggish, but we are not eager to be short this market. Aside from smaller-than-anticipated US winter wheat acreage, frigid temperatures may have caused damage in key growing regions in the US plains. Traders will be focusing on every weather scare.

In the realm of technical analysis, wheat prices are definitely in the throes of a bear move. For the moment, however, the market has stopped falling, having consolidated above support levels established back in the fall (Chart 7) – a reflection, perhaps, of the mixed signals we described above. Stand aside.

[By Sholom Sanik, March 4, 2015]

©2015 by Friedberg Mercantile Group Ltd. Reproduction in whole or in part prohibited.

Chart 7 – Weekly nearest contract wheat

Courtesy Bloomberg LP

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 © 2015 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:
Friedberg Mercantile Group Ltd.
Suite 250
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits. This report is a solicitation for entering into a derivatives transaction. The author of this report may have a position in the underlying derivative securities mentioned in this report. The information in this report was obtained from sources we believe to be reliable but is not guaranteed by Friedberg Mercantile Group Ltd. or its affiliates. Derivatives are high-risk investments, and there can be no assurances that the securities mentioned or recommended will maintain their value at a constant amount or that the full amount of your investment will be returned to you. Derivatives' values change frequently and past performance may not be repeated.