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Surprising strength for cocoa prices

The recent activity in the cocoa market can be best described as counterintuitive. The market has rallied sharply for no *apparent* reason (Chart 1). Even the typical peripheral reasons often cited, such as a weak US dollar or broad commodity strength, would not have applied. The dollar has been directionless, and commodities, if anything, have been getting clobbered.

Short-covering by funds can hardly be blamed either. The most recent Commitment of Trader data show that speculators increased their net-long position by more than 9,000 contracts from the previous week, to hold their largest long position since January.

Ivorian output is the single most important factor that determines cocoa prices. Despite bumps and grinds in weather conditions along the way, the 2012-13 crop has fared well. Port arrivals stand at 1.064 million tonnes, down about 1% from last year at this time.

The main crop is just wrapping up, and farmers are beginning to ship early mid-crop beans. The consensus of analysts is that the mid crop should do well, with a median estimate of 400,000 tonnes, higher than the 5-year average. January and February were dry, delaying the onset of the mid crop, but then the rains picked up. Total 2012-13 production should meet last year's 1.4-million-tonne output level.

Butter prices have maintained their recent strength in both Asia and Europe, at about 1.75 and 1.95 times the London spot price, respectively. Powder prices continue to weaken, however, and have fallen to below \$2,500 per tonne, down from \$5,000 per tonne a year ago. Weak powder prices have dragged down the combined ratio (Chart 2) to its lowest level in many years.

A degree of tightness seems to have developed in the butter market, because the two main products are sold as a package, and processors are reluctant to sell when the combined price is so low. Still, this does not explain strong bean prices.

Amid the anecdotal evidence of product hoarding and the resulting buildup of butter and powder inventories, there was a glimmer of hope on the demand side. Fourth-quarter grind figures for North America showed surprisingly strong activity, perhaps in anticipation of stronger consumption trends. Analysts were expecting the grind to come in between -1% and +1%, but the actual number was +6%, the biggest jump in two years. The

headlines took note of the news, but the market has not advanced in earnest since the data were released on April 18.

Attaching too much significance to the North American grind, however, is premature, because the other key grinding regions continue to see flat to negative growth. Europe grinds roughly three times as much as North America, and its fourth-quarter grind was down 4%, in line with expectations. In Malaysia, Asia's largest processor, the grind fell by 3.2%.

The supply/demand fundamentals seem to warrant a short-sale recommendation. Indeed, for short-term traders, it would seem to be a reasonably decent bet. We are reluctant, however, to be short this market.

World supplies have kept pace with demand, but only because demand growth has been anemic. The handful of producing countries that grow 75% of the world's beans have not been successful in advancing output growth, try as they might. We constantly hear about reforms in the Ivory Coast that are designed to put more money into the hands of farmers in an effort to stimulate more spending on fertilizer and other crop-enhancements. But it has not happened. We anticipate a range-bound market for now.

Remain sidelined.

[By Sholom Sanik, April 24, 2013]

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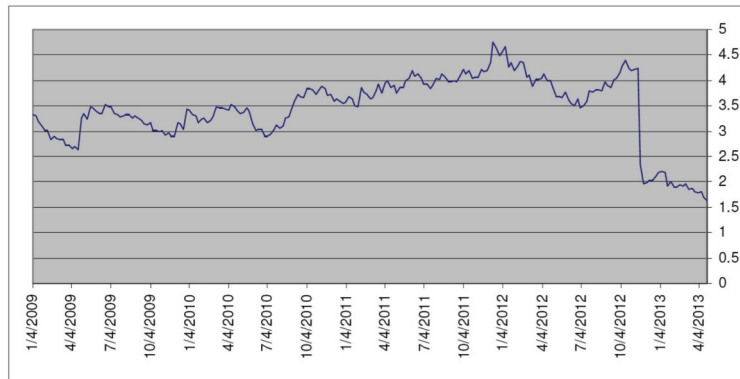
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Chart 1 – July cocoa



Courtesy Reuters

Chart 2 – Combined cocoa butter/powder ratio



PALLADIUM

Running out?

In early April, palladium prices attempted a run at the \$800-per-ounce level, but were thwarted – quite likely – by the collapse in gold prices. Chart 3 shows that palladium was moving independently, responding to what have become very bullish supply/demand fundamentals. At about the same time that gold peaked at \$1,750 per ounce back in October, palladium began a close-to-\$200-per-ounce rally that held right up until gold broke below \$1,600 per ounce. Palladium could not withstand the winds of liquidation.

Palladium may be rare, but it is not a precious metal, at least not in the same sense that gold is, because its investment sector is negligible. While volatility in gold prices may affect palladium prices in the short term, palladium should not be beholden to the broad precious metals investment climate.

Just about all available palladium supplies are used for industrial purposes. About 70% is used as a catalyst for the

exhaust systems of motor vehicles. The balance is used by the jewelry, chemical, and dental industries.

Palladium has taken auto catalyst market share from platinum over the past 10 years. Johnson Matthey (JM) estimates 2012 global platinum auto catalyst demand at just over 3 million ounces. That’s down from the 2007 peak of over 4 million ounces. Palladium demand during this period, on the other hand, experienced explosive growth. JM estimates 2012 usage at 6.5 million ounces, up from 3.5 million ounces in 2003.

The bullish case, however, is not strictly a demand side issue. The market is absorbing a supply-side shock from two fronts. Roughly 80% of world supplies are mined in two countries, Russia and South Africa.

About 45% of annual global supplies come from Russia. In recent years, about two thirds of Russian supply was newly mined, with the balance coming from stocks. Between

2005 and 2011, Russian exports from inventory averaged 900,000 ounces per annum, or about 11% of total world demand. In 2012 that number shrank to about 250,000 ounces, representing only 3.3% of global demand. Although the actual size of the Russian stockpile is a closely guarded state secret, industry analysts believe that there are little or no stocks remaining.

There are new mining projects that will eventually produce more palladium, but we are talking about 10 years down the road.

To complicate matters, serious labor strife in the world's second largest supplier have debilitated some key mines in South Africa. Strikes at Anglo American Platinum Ltd. mines have caused the company to pare back production, eliminating a significant amount of production from the market. The company is in talks with the government about closing some mines indefinitely, but either way, supply will be curtailed for the foreseeable future.

As a result of these supply issues and growing demand, there was a global supply/demand deficit of 915,000 ounces in 2012, a complete turnaround from a 1.26-million-ounce surplus in 2011.

Palladium prices have increased substantially *vis-à-vis*

platinum prices since mid-2009. Where substitution is an option and the cost is an issue, platinum might have priority. Chart 4 shows that palladium prices were much higher in the early 2000s, but then again, the explosive growth in auto catalyst demand may have only been facilitated by much lower palladium prices we saw between 2003 and 2009. So demand could prove to be elastic to some degree, especially if prices continue to rise.

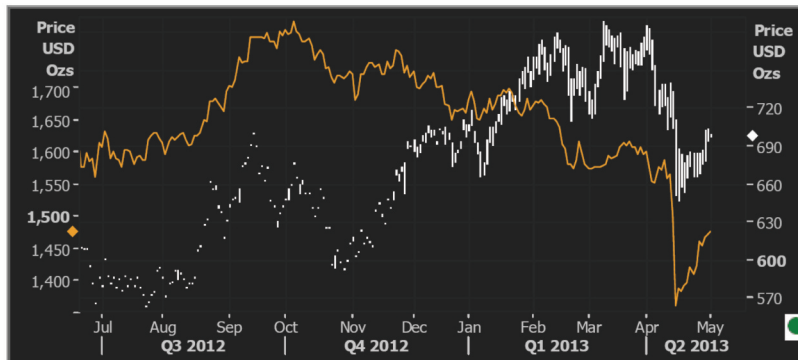
We believe, however, the recent selloff was an over-reaction to the general drop in metal prices. The instability of supply lines from both Russia and South Africa remains the dominant issue. South African mine production will not grow anytime in the near future. And if Russia has indeed depleted its stocks, we will be looking at another global supply/demand deficit in 2013.

Prices will need to move much higher to incentivize infrastructure investment. Even so, in the near term, supplies will remain very tight, and we expect prices to rebound back to the highs and beyond.

Buy June palladium. Place sell stops at \$650 per ounce, basis June, close only. This is a very illiquid market. We recommend a conservative trading approach.

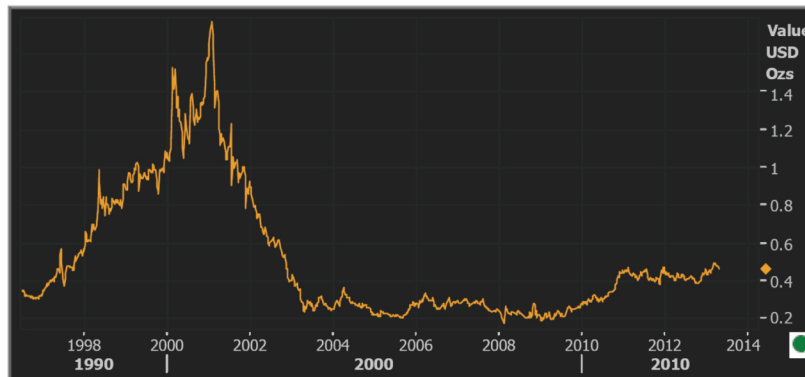
[By Sholom Sanik, May 1, 2013]

Chart 3 – June palladium (bar), June gold (line)



Courtesy Reuters

Chart 4 – Palladium/platinum ratio



Courtesy Reuters

GOLD

Big picture unchanged

Long gold holders were taken for a wild ride over the past couple of weeks, enduring one of the largest one day selloffs in history on April 15 as panic gripped the market. By the end of the rout, gold had fallen more than 15% peak-to-trough in just three trading sessions, bottoming out at \$1,321.50 (basis June futures), a level not seen since fall 2010. Gold has since rallied smartly (Chart 5), retracing over \$150 of the selloff. What is one to make of such a move?

The selloff in gold has sparked what can best be described as a new gold-rush, as investors clamor to buy physical gold. Evidence of the strong physical demand can be seen in the premiums investors have been willing to pay above market value for access to bullion. Prior to the yellow metal's "flash crash," wholesalers in Dubai were paying about 50 cents above the London cash price, and are now paying premiums of between \$6 and \$9 an ounce. In Istanbul, one of the largest gold trading hubs, premiums have reached as high as \$25 per ounce. In China, volumes on the Shanghai Gold Exchange set a new record high last week, and countries from the US to Australia have reported feverish buying of gold coins, causing shortages.

The strong investor demand has not been mirrored in gold ETFs, where we've observed a significant decline in the number of ounces held in trust. Since December of last year, total known ETF holdings of gold have declined by about 13%, the largest and most protracted decline since the advent of physically-backed precious metals ETFs (Chart 6).

Aside from thus far unrealized expectations for inflation (at least in official figures) arising from record money-printing around the world, the strongest argument in gold's favor is the return of central banks to the demand side of the gold market.

For decades, central banks were supplying gold to the market as they diversified away from non-interest bearing bullion into the government bonds of reserve currency countries. Last year, however, central banks added approximately 530 metric tonnes to their reserves, the most since 1964 – and this does not include China, which is believed to be a heavy buyer of the metal. Turkey, South Korea, and Brazil all nearly doubled their gold holdings in 2012, and Russia also significantly increased its holdings. Combined, these four central banks purchased 368 metric tonnes through February year-over-year, constituting the bulk of disclosed central bank purchases. At the same time, there were no notable sellers among central banks.

The buying bonanza seems set to continue in the years to come. In Switzerland the Swiss People's Party, the largest in the Federal Assembly, has collected the 100,000 votes necessary to call a national referendum requiring the Swiss National Bank to hold at least 20% of its reserves in gold. If passed, the proposal would require the SNB to almost double its current holdings by buying more than 1,000 tonnes of the yellow metal.

Long positions are not without risk. The selloff was preceded by news that Cyprus would sell €400 million worth of gold to help finance its bailout. While Cyprus has a relatively small amount of gold, other troubled European states do have significant holdings. Combined, Portugal, Spain, Italy and Greece own 3,228 tonnes.

We remain long-term bulls on gold, and see value at current levels. Volatility is prone to arise, so stops should be placed carefully.

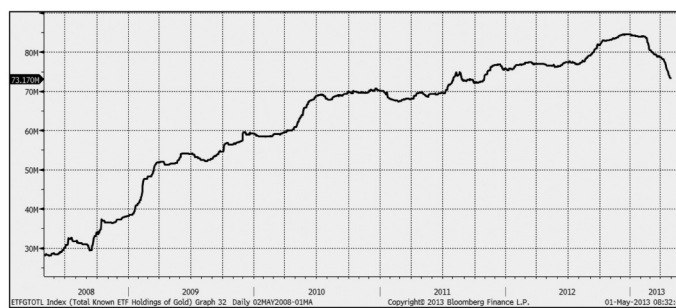
[By Jaime Macrae, May 1, 2013]

Chart 5 – June COMEX gold



Courtesy Bloomberg LP

Chart 6 – Total known ETF gold holdings



Courtesy Bloomberg LP

COTTON**Why aren't burdensome stocks pushing prices down?**

The March 28 Planting Intentions Report showed that US farmers will plant 10.026 million acres for the 2013-14 cotton crop to be harvested this coming fall, down from last year's final planting estimate of 12.701 million acres. The forecast was near the low end of analysts' guesstimates. New-crop contract months rallied for a few days in response, but the 88-cent-per-pound level proved to be a near-term top. Prices proceeded to drop in the weeks that followed, by about 5¢ per pound, before finding some support at the 85-cent-per-pound level (Chart 7).

We pointed out in our last discussion of cotton (see *Focus on Futures*, March 5) that even with the push towards the 90-cent-per-pound level, it was still more profitable to plant soybeans or corn. No doubt the rally that began in November inspired some additional acres, but a new dynamic was introduced into the market that could be even more instrumental in expanding US cotton area. It has been a very wet late winter and early spring, which has delayed corn planting. In regions where the optimum window for planting corn will close before farmers can get into the fields, cotton planting will be a viable alternative. Some analysts say that we could see as many as 1 million acres added to cotton area. The recent selloff in December cotton back down to 83¢ per pound reflected expectations for larger plantings.

As far as the other major producing nations are concerned: China and Australia will plant smaller crops as well, but Brazil, India, and Pakistan will see an increase in cotton area. Total global production is expected to decline by about 3%, to 115.5 million bales. However, with a modest 2.6% increase in global consumption, to 109 million bales, burdensome inventories will continue to grow.

US exports have been surprisingly strong and have provided some support to the market. Commitments were lagging behind last year's pace as recently as early April, but have now pulled ahead of last year by close to 1 million bales, and are in perfect position to meet the USDA's upwardly-revised target for 2012-13 sales of 13 million bales. But is it enough?

It's quite possible that global cotton usage is in a long-term decline. During the mid 2000s, annual global consumption peaked at over 120 million bales. The global recession certainly affected cotton demand, as it did for most every commodity, but cotton lost market share to synthetic fibers as well.

The estimates for burdensome global inventories continue to inch up every month. The April USDA crop report revised 2012-13 ending stocks up to 82.45 million bales, or

76.8%, up from the 76.3% March estimate. As illustrated above, that stockpile should continue to grow in 2013-14.

Sounds like a great short? There are several reasons why it is not. Cotton has regained some lost market share to synthetics over the past two marketing years. The growth spurt for synthetic fiber *vis-à-vis* cotton has likely plateaued. While this in itself does not account for an appreciable increase in cotton usage, and the recent jump in US sales does not guarantee that demand will return to mid-2000 levels, it is commensurate with the world's slow climb out of recession.

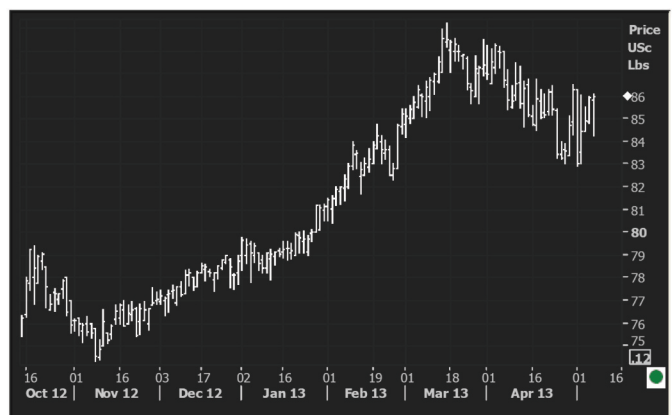
Cotton usage could return to mid-decade levels. The evidence at the moment suggests that this is possible. We pointed out in our last article on cotton (see *Focus on Futures*, March 4) that despite the impression we get from headlines, China is not the only cotton customer. In notes accompanying a recent cotton report, the USDA points out that Indonesia, Thailand, and Vietnam are importing record volumes of cotton this marketing year.

Even if acreage benefits from corn switching, US cotton acreage is at its lowest level since 2010, which could make the market vulnerable. The uncooperative planting weather has slowed down cotton seeding as well. As of the most recent planting progress report, only 17% of the crop had been planted, down from 35% last year at this time and still well below the 5-year average of 27%. The same vulnerability applies to the other key producers.

In the meantime, cotton prices are hovering well above historical highs. We're still nursing a long-held long position with a stop at 77.5¢ per pound, basis December. Raise stops to 82.5¢, close only.

[By Sholom Sanik, May 8, 2013]

Chart 7 – December cotton



Courtesy Reuters

CORN**Better get that crop planted!**

The March 27 USDA US Planting Intentions and Quarterly Stocks Reports broke the back of the corn market...well, sort of. The two reports showed that more acres than expected will be planted and that March 1 stocks stood at considerably higher levels than analysts had forecast, respectively (See *Focus on Futures*, April 5). Prices fell sharply. There has been a lot of noise since those two reports were released – including a rally back to prereport levels – but prices have since fallen back to the lows (Chart 8).

The April 11 USDA crop report was a nonconfirmation of the stocks report, though, because the estimate for domestic feed was not as weak as analysts had expected, which created some confusion. The crop report seems to be the more accurate reflection of the current old-crop situation. Spot corn prices are still trading 50¢ per bushel above May futures, indicating that the market remains tight. It is widely expected that 2012-13 ending stocks will remain scarce until new-crop supplies are available in the fall.

Attention has therefore turned to new-crop issues. The early part of the planting season has been a disaster. Heavy rain in some regions and late snow in others resulted in very wet fields that did not allow farmers to start planting their crops. The May 6 weekly planting progress report showed that only 12% of the crop had been planted. That is down from the 5-year average of 47% at this juncture of the season and dramatically below last year's 69%.

There is drier weather in the forecast that should allow some serious catch up. The concerns are that late planting could result in some yield loss, and in some regions, the planting window could close completely, forcing farms to plant soybeans or cotton instead.

Studies of previous late-planted crops show that over the past 30 years, there was significant acreage and yield loss about half the time, which makes historical precedent inconclusive. Besides, analysts have rationalized that we have an edge and that there is no need to panic at this point for two reasons. First, the extra moisture is welcome after last year's debilitating drought left many fields with inadequate subsoil moisture to accommodate a high-yielding crop, and that could increase yields. Second, any comparison of late planting between 2013-14 and other years is not reliable, because advanced technology has brought genetically modified seeds that require less moisture and shorter growing seasons.

China, the world's second-largest producer and consumer of corn behind the US, is experiencing widespread weather-related planting delays as well. The northeast is wet and the northwest has drought.

Mitigating the potential for smaller-than-expected Northern Hemisphere 2013-14 crops, to some degree, are the excellent results being achieved in Brazil. The 2012-13 harvest is not complete, and ideal growing conditions have resulted in upwardly-revised estimates. The April USDA estimate was 74 million tonnes, revised up from the 72.5-million-tonne March estimate. Some analysts have raised the forecast to 76.5 million tonnes. It reads well in the headlines, but it would be a drop in the bucket if set against a Northern Hemisphere crop failure.

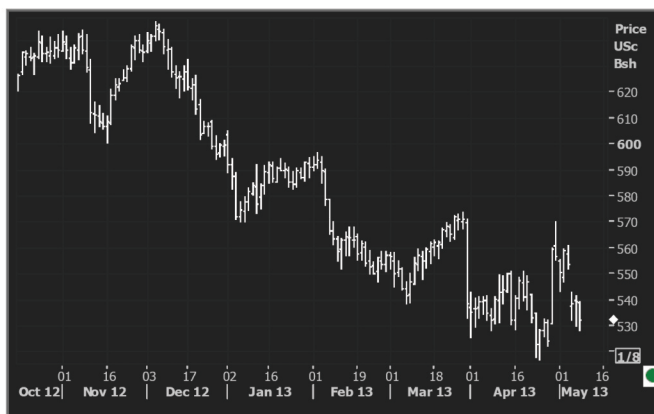
The coming US crop is expected to replenish inventories. At 14.5% of consumption, 2012-13 global ending stocks are at their lowest level since 1973-74. As illustrated, farmers should get the crop in the ground eventually, and there is a better than even chance that we'll muddle through and avoid a disaster. However, at present, with the prices hovering near the recent lows, it would seem that the market is discounting a normal crop.

Our April 5 recommendation was "... to follow the weather and buy new-crop months at the slightest hint of a disappointing crop." Well, we believe we're there. We are not predicting further bad weather. Rather, we believe that the US crop is highly vulnerable, and the market is presenting a potential low risk/high reward trade if anything short of perfect conditions does not appear – real soon.

Buy December corn, place initial stops at \$5.05, close only. Alternatively – for the more patient trader – surrender a little territory and wait for the market to declare that things aren't going as well as they should be. Place buy stops at \$5.50, also close only, to enter the long side.

[By Sholom Sanik, May 9, 2013]

Chart 8 – December corn



Courtesy Reuters

CRUDE OIL**WTI-Brent crude: moving oil to a new normal**

Probably the most closely watched spread in the commodity universe is that between Cushing, OK-based West Texas Intermediate (WTI) crude oil, and the North Sea-based Brent crude oil. The relationship between the two largest benchmark prices for global crude oil was historically very tight, with Brent typically trading a few dollars below WTI. In 2010 the balance shifted dramatically, Brent crude skyrocketed relative the WTI, and what was once a sleepy spread market became extremely volatile (Chart 9). It is important to note that this was not a case of European or world oil prices rising relative to US crude, as most benchmark prices, both globally as well as in the US, kept pace with Brent. The widening of the WTI-Brent spread was the direct result of a large buildup of supplies in landlocked Cushing, OK, which was unable to reach the global market, and therefore began to trade at a discount.

Supplies in Cushing may have been the cause behind the expanding spread differential. However, the supplies themselves were merely a symptom of a much larger structural shift in the US crude market that will most likely have a pronounced effect on domestic supply and by extension on world prices for years to come. Technological advances that were initially developed to extract natural gas from shale deposits (and have since depressed domestic gas prices, Chart 10), were applied to so-called "tight oil," allowing domestic production to surge over the past few years. The greatest successes have been found in the Bakken Shale in North Dakota, where only five years ago, crude oil production was hovering around 100,000 bpd and was on the decline. It has since grown to over 715,000 bpd, which is roughly equal to the production of OPEC member Qatar. Altogether, domestic production of crude oil in the US has soared, reaching levels not seen since the early 1990s (Chart 11).

Since the beginning of February, the discount of WTI to global prices has fallen quickly, due primarily to changes in pipeline infrastructure that has brought cheaper mid-continent crude oil to the US Gulf coast. The Seaway pipeline was reversed in May 2012, and now moves crude oil out of Cushing into the Houston area. However, the volume was expanded only in January of this year, and in February it transported an average of 272,000 bpd. By this

time next year, they expect the pipeline to be moving 800,000 bpd. Despite US crude inventories reaching record highs, supplies in Cushing have been on the decline since the Seaway reversal. Balance is slowly being restored to the crude market, and the WTI-Brent spread looks set to return to its historical equilibrium. But that is unlikely to last for very long.

Similar to the exponential growth of tight oil production in the Bakken shale, the Eagle Ford shale in Texas has experienced tremendous growth over the past few years. Even in 2009, production from this unconventional source of crude was virtually non-existent. By 2012, though, over 350,000 barrels per day were being extracted. This has displaced much of the remaining light crude imports into the Gulf. As of the end of 2012, the US was importing only about 500,000 bpd of light crude (many of the refineries invested substantially in order to process heavier grades) into Gulf Coast refineries, and imports are falling fast.

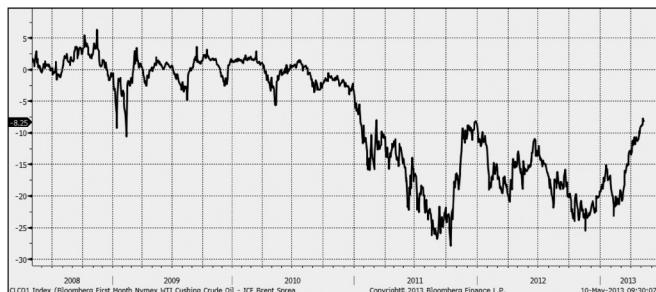
Assuming trend-line growth in Eagle Ford production, and an increase in flows from the Seaway pipeline, WTI may be escaping one oversupplied market into another. This time, however, the differential will be spread across a wider base, and the adjustment to higher supply will have a broader effect.

Until now, the discount to Brent has been confined to WTI and a handful of other local markets that lack sufficient transport capacity. But with the glut of supplies spreading to the Gulf, benchmark Louisiana Light Crude (LLS) may soon start trading at a discount to Brent as well, which until now has not happened (Chart 12). This would be significant, as it would be an arbitrageable link between inland tight oil production and the world market.

We have held a long-term bearish view on crude oil, inspired in part by the large-scale exploitation of unconventional sources. Shorts should be cautious, however, because of the constant risk of a military standoff with Iran, which could disrupt as much as 40% of the world's seaborne crude, which passes through the Strait of Hormuz. There are several strategies to protect yourself from temporary disruptions, including options and spreads.

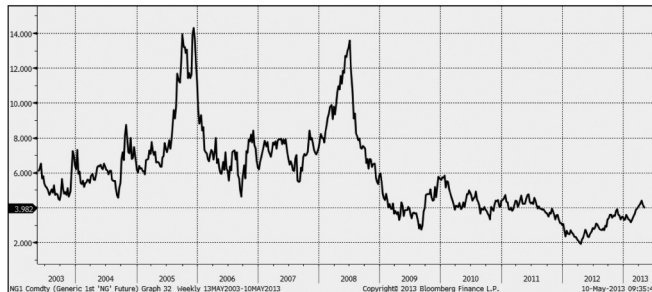
[By Jaime Macrae, May 13, 2013]

Chart 9 – First month WTI-Brent crude spread



Courtesy Bloomberg LP

Chart 10 – Long-term US Henry Hub natural gas



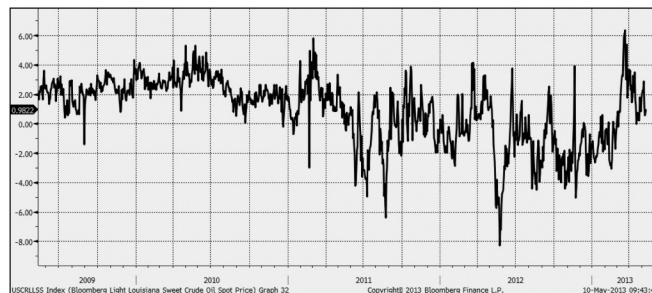
Courtesy Bloomberg LP

Chart 11 – US total crude oil production



Courtesy Bloomberg LP

Chart 12 – Louisiana Light Sweet – Brent crude spread



Courtesy Bloomberg LP

COPPER

The bull's last hurrah

Copper prices fell to a two-year low earlier this month. The other London-traded base metals followed a similar pattern (Charts 14 - 18). In what we view as merely extremely oversold conditions, copper staged a mighty 10% rally. The other metals consolidated but continued to hover near their lows. An indication, perhaps, that the recovery in copper prices was tied more to short-covering than a resurgence in demand for industrial metals. Indeed, we find that the supply/demand situation for copper continues to head in a bearish direction.

On May 1, The International Copper Study Group (ICSG) released its most recent report, which showed that the global balance sheet posted a 67,000 tonne surplus for January. Although 2012 ended with a 396,000-tonne deficit, that shortfall contracted sharply over the past few months – by over 100,000 tonnes. And it would seem from recent developments that this will continue. ICSG estimates that 2013 will end with a surplus of 415,000 tonnes, the first time the market will be in surplus since 2009.

Chilean copper output grew by 3% in 2012, below

initial optimistic estimates. Thus far in 2013, however, forecasts for output growth of between 5% and 10% appear to be achievable. Despite a sluggish February, in which output grew only 2.8%, and ongoing labor strife, average monthly output is up 6.5% versus the same period last year.

Warehouse stocks continue to build. At just under 900,000 tonnes, combined inventories at LME, COMEX, and Shanghai warehouses have more than doubled over the past year (Chart 19). And that is on top of the 500,000-tonne-plus stockpile rumored to be held at bonded warehouses in China.

China continues to be the world's largest importer and consumer of copper, but imports are in a downtrend. April imports were 7.4% below the previous month and were at their lowest level in 22 months. Import volumes have fallen by roughly 40% from their late-2011 peak (Chart 20). Naturally, even with some countries slowly recovering from the global economic crisis of the past several years, there are no countries or regions that can compensate for the sheer magnitude of Chinese overseas purchases.

Rising energy and labor costs worldwide have driven production costs up over the past few years, but copper prices remain well above the cost of production. Costs vary from mine to mine and region to region. The costs we surveyed averaged between \$1.50 and \$2 per pound. Still, it is a very profitable business, and where unimpeded by weather and labor problems, mining companies will produce as much as they can. With Chinese buying possibly in a long-term decline, global demand may not be sufficient to sop up excess production.

A study of open interest and CFTC commitment of

trader data confirm that commodity funds were heavily short. The building of that short position was probably a strong contributing factor to the sharp decline in prices that began in early February, bearish fundamentals notwithstanding. During the recent rally, open interest dropped sharply and the net-short position was trimmed by over 20,000 contracts (Chart 21)

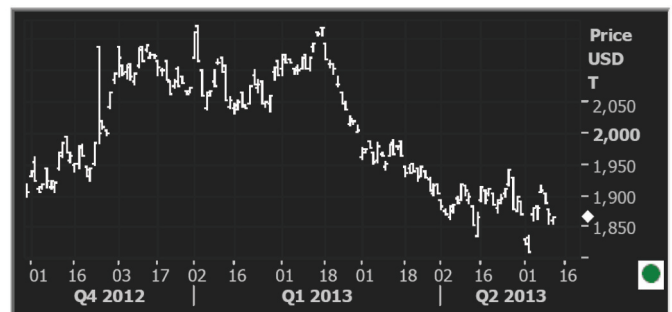
We believe that this rally warrants establishing new short positions or adding to existing ones. Lower our long-standing buy stop at \$3.85 per pound, basis nearest active contract, to \$3.45. *[By Sholom Sanik, May 14, 2013]*

Chart 13 – July COMEX copper



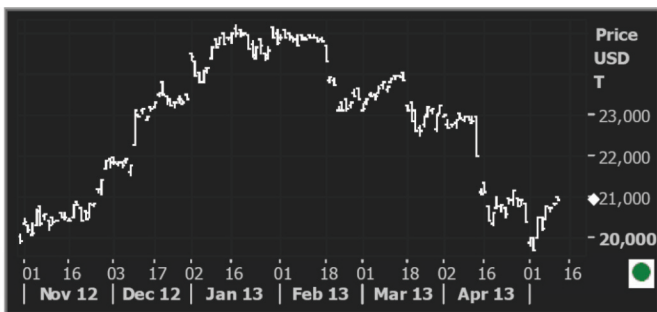
Courtesy Reuters

Chart 14 – 3-month LME aluminum



Courtesy Reuters

Chart 15 – 3-month LME nickel



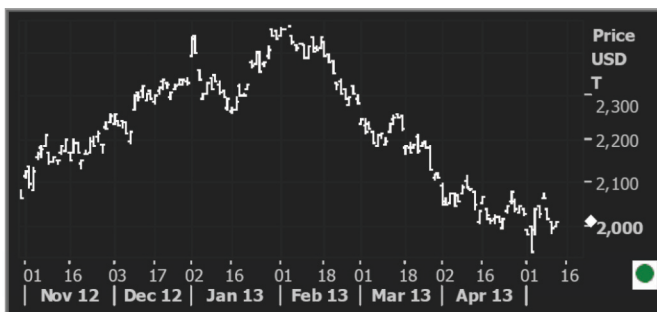
Courtesy Reuters

Chart 16 – 3-month LME zinc



Courtesy Reuters

Chart 17 – 3-month LME lead



Courtesy Reuters

Chart 18 – 3-month LME tin



Courtesy Reuters

Chart 19 – Combined warehouse stocks

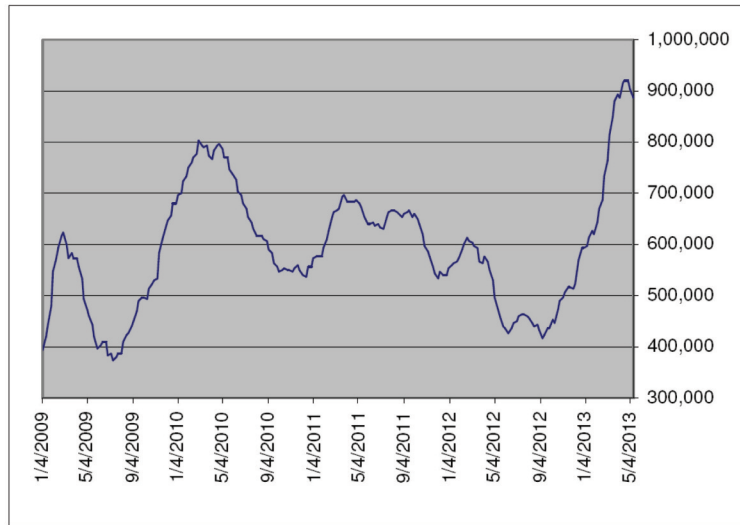
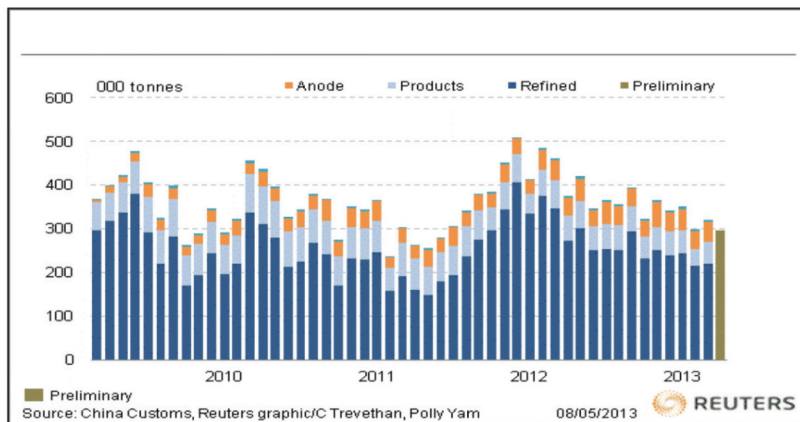
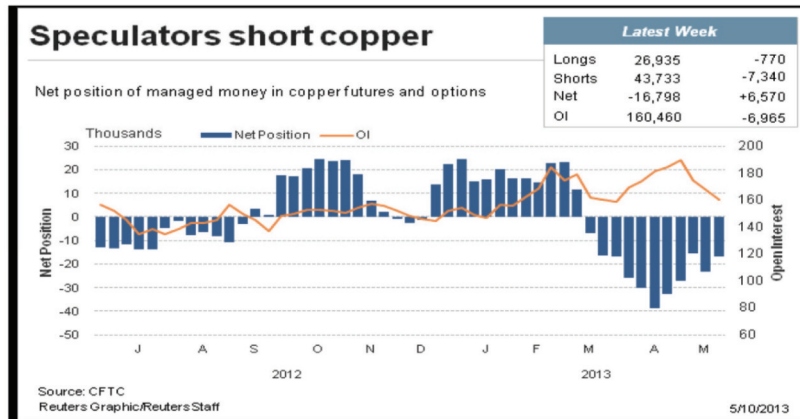


Chart 20 – Chinese copper imports



Courtesy Reuters

Chart 21 – Net-short position (bar), Open interest (line)



Courtesy Reuters

US TREASURY BONDS**US 30-year bonds: confusion breeds opportunity**

The month of May started out on a strong economic footing, with US April non-farm payrolls surprising to the upside, adding 165,000 jobs (more than the 140,000 expected), as well as revising the March number up by 50,000 jobs. The Treasury market began what would be a multi-week selloff (Chart 22) as speculation mounted that the Fed would begin to taper off asset purchases, which are as of now open ended at \$85 billion per month. Meanwhile, Bill Gross, manager of the world's biggest fixed-income fund, tweeted that the 30-year secular bull market in bonds had ended on April 29. It now appears that the optimism was somewhat premature, as economic data this week painted a much gloomier picture of the US economy's health.

On May 15, the first of the bad headlines hit the wires when the Empire State Manufacturing survey of general business conditions came in negative (-1.43), while expectations were for a positive reading of 4. This was accompanied by a disappointing Producer Price Index, which revealed a larger-than-expected month-on-month contraction in prices (-0.7%), and year-on-year growth barely half of what it was the month before (0.6% vs. 1.1% in March).

On May 16, data on the Consumer Price Index showed a similar contraction in April. Later in the day, upon the release of the surprisingly negative Philadelphia Fed survey (-5.2 vs. expectations for +2.0), the Treasuries rallied further, and Mr. Gross took to Twitter once again to equivocate on his earlier statement, saying, "30-yr bond bull mkt over but bear mkt begins only with consistent 2-3% real and 4-5% nominal GDP growth. Not there yet. Maybe never."

Federal Reserve officials did little to alleviate the confusion. Federal Reserve Bank of Boston President Eric Rosengren, of the dovish camp and a voting member of the FOMC, defended the current Fed policy to a banking conference in Milan, saying, "Monetary policy has been quite effective in offsetting the contractionary effects of recent fiscal policies," essentially passing blame for the lackluster success of the Fed's easy money policies to the government. He also indicated that further monetary easing may be required to spur growth in the economy and keep inflation at the target 2%, dampening speculation of an early end to asset purchases.

Meanwhile, speaking at the same conference, Philadelphia Fed's Charles Plosser (who does not currently have a vote) poured gasoline on the fire saying that asset purchases should be tapered off starting in June.

We have been steadfast bulls on US Treasuries, even at ultra-low yields. With a great deal of uncertainty surrounding the European fiscal crisis, doubts as to the strength and sustainability of the US recovery, and the likelihood that extremely accommodative Fed policies (not to mention outright asset purchases) will stay in place for the foreseeable future, the safety and liquidity of US Treasuries is hard to beat. Weakness should be viewed as a buying opportunity. Favor the long end of the curve (30 years) where real yields are still positive (Chart 23) over the 10-year notes, which have a negative return after inflation expectations (Chart 24).

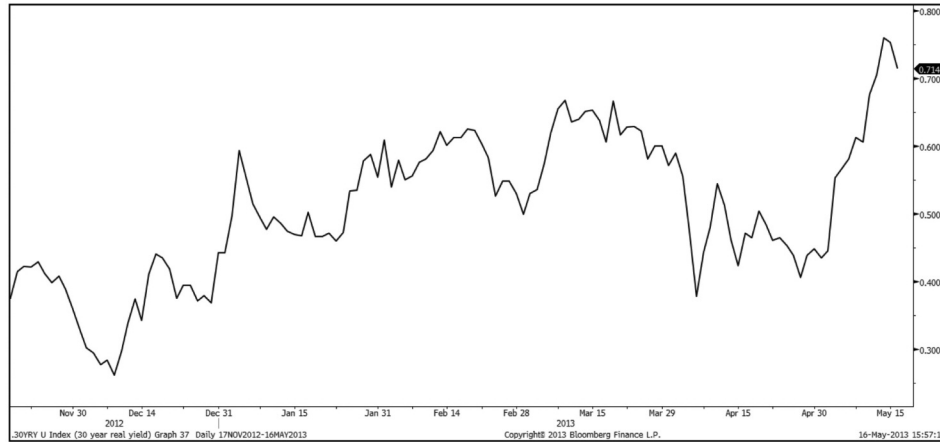
[By Jaime Macrae, May 17, 2013]

Chart 22 – US 30-year Treasury bond futures



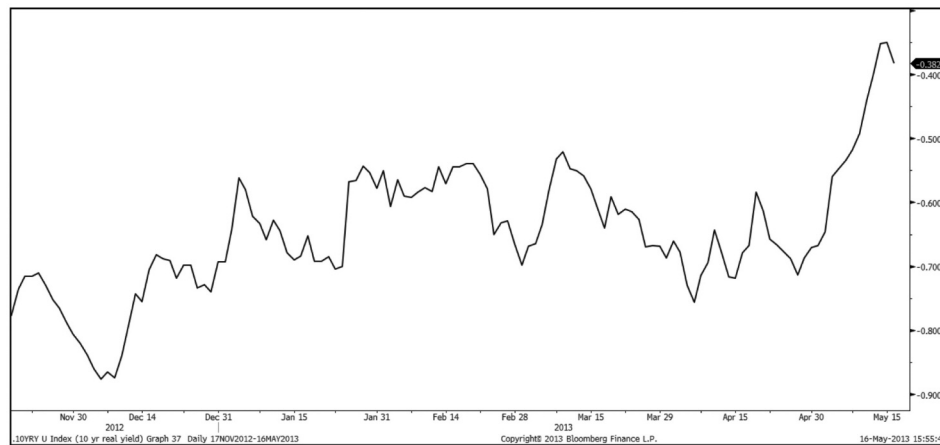
Courtesy Bloomberg LP

Chart 23 – US 30-year real yield



Courtesy Bloomberg LP

Chart 24 – US 10-year real yield



Courtesy Bloomberg LP

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