

# FRIEDBERG'S

FOCUS ON FUTURES

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## Cocoa: looks terrible, but looks can be deceiving

Recently, we referred to cocoa (*Focus on Futures*: “Are these fair prices for wheat?” April 30) as the sad-sack benchmark of commodity markets. Indeed, with production growing at a faster pace than consumption and the enormous carryover stocks that result, what hope is there for a bullish revival of this market? Using cocoa as the standard for commodity bear markets is certainly not a far-fetched notion.

Readers might find these bleak comments about the cocoa market a bit puzzling. In an April 12 article about cocoa (“*Still abundant, but, demand improving*”), the tone was decidedly positive for the future. In fact, we stopped just short of making a buy recommendation in that article and have since jumped on the long side. The explanation is quite simple. Current price levels – of this or any instrument – are a reflection of the participants’ perception of the fundamentals; hence, the weak prices and all the trappings of your classic bear market. Our budding bullishness, however, is based on the belief that some of those perceptions are inaccurate.

On the surface it would be hard to make a case in which the supply side is anything but bearish. For years, we’ve heard talk of aging cocoa plantations in West Africa and Southeast Asia whose trees had passed the apex of their productive years. Still, the top three producers – the Ivory Coast, Ghana, and Indonesia – continue to churn out record-size crops from the allegedly geriatric trees. If the trees are still able to produce, should we assume that the trend of higher production will continue? We think not.

Bull markets begin in earnest when producers’ profit margins have been squeezed so tight as to render production uneconomical. Some farmers can’t hold on at all, others curtail output and perhaps plant alternate crops. First we see the rate of growth of production shrink. Ultimately, output will drop below the previous period’s level. It’s a long and boring process.

A good example of this process is the wheat market where world production has been in decline since the 1997-98 season with prices crawling along the bottom of their range. The first indication that this might be happening in the cocoa market is emerging at these price levels. The average cash cost of production to farmers in the Ivory Coast is

roughly \$370 per tonne. Despite the world price level of \$800 per tonne, Ivorian farmers receive little more than half the world price even after the new system went into effect. Labor costs fluctuate, and when their labor costs are at the high end of the wage scale, they earn little.

So while exporters are still earning tidy profits, the part of the production infrastructure that needs the most incentive to continue producing bumper crops is not getting it. Yes, the numbers are showing big crops; however, at these prices we think that the cycle has come full circle.

We also feel that the market is ignoring a changing landscape on the demand side. The first-quarter European grind numbers were released in early April and rose by a higher-than-expected 5%. US grind numbers were released on April 28. The street was calling for an increase of 10%, but the US numbers were also stronger than expected, rising 12.3%.

The difference between the expectations for the US grind and the reported number amounts to only 2,200 tonnes – statistically an insignificant amount considering that total grindings are over 2.9 million tonnes. However, in terms of the reported global production/consumption surplus of 91,000 tonnes, it is more significant.

The market certainly took the view that there was little in

### In this issue

- 2 Platinum**  
Bursting with bullish fundamentals:  
supply and demand side, short- and long-term
- 4 Wheat**  
Will falling production usher in a bull market?
- 6 Post mortem**  
Corn and Canadian dollar
- 8 Hotline Update**

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

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the US grinding numbers to get excited about despite the better-than-expected figures; July cocoa sank to new contract lows on the very day of the report.

Cumulatively, first-quarter grindings of the big four Western chocolate-producing nations rose 7.5%. When put together with grindings in origin countries, which have definitely been growing at a faster pace than production, we should easily return to production/consumption deficits in short order.

The weakness in this market has been caused in large part by a huge contingency of speculative short sellers. The most recent commitment of traders data show that while the com-

mercial community has been moving steadily to the long side of the market, the funds have increased their net short position.

At 111,000 contracts, the open interest is massive. At the moment – with the market tilting to the downside – the bears are in control and the bulls are the vulnerable group. As illustrated above, we believe that the long-term fundamentals have turned bullish, and with prices so low any bullish surprise from either the demand or supply side would cause a tidal wave of short-covering. [May 9, 2000]

**CURRENT STRATEGY:** Remain long July cocoa as per Flash Update of May 2. Raise stops to 770, close only.

Chart 1 – July Cocoa



Chart courtesy of Reuters

## PLATINUM

# Bursting with bullish fundamentals: supply and demand side, short- and long-term

News back in April that Norilsk Nickel had begun shipping platinum sent prices into a \$75-per-ounce nosedive. European dealers reported that they were seeing small amounts trickle in. Analysts figured that this finally marked the end of the nonsense that had kept platinum exports tied up in a bureaucratic quagmire since mid-1999. Well, the trickle is still a trickle, and platinum prices have since recouped all of the recent losses (Chart 2). Where is the Russian platinum hiding?

Quite frankly, we have no idea. As long as meaningful amounts do not appear, we can only surmise that the “miss-

ing” platinum does, in fact, not exist. Since 1994, the Russians have been supplying the market with anywhere from 900,000 to 1.3 million ounces annually. In 1999 that figure dropped to 540,000 ounces. After passing all the legislative hurdles, it would seem that there should be no good reason for the metal not to start moving. The theory floating around that the Russians are trying to create a squeeze by sitting on the inventory makes for a nice story. However, it is unlikely that Norilsk Nickel or any group in Russia that stands to benefit from platinum sales abroad is in strong

enough financial shape to afford the lost revenue.

Before Russian exports were halted, it was assumed that they had 800,000 ounces available for export in 1999. Having shipped only 540,000 ounces, there are 260,000 ounces whose status is in question. If the Russians really don't have the 260,000 or so ounces that they would have otherwise sold last year, the supply/demand balance looks wildly bullish. With the books closed on 1999, the recently released Johnson & Matthey report increased the production/consumption deficit by 200,000 ounces to 730,000 ounces. This is by far the biggest deficit in modern history.

If the flow of Russian platinum were to turn from a trickle into more of a flow, it would be difficult to maintain these prices. However, we feel that after the initial adjustment period, i.e., a dramatic selloff, the market would stabilize. The fundamentals of this market – even without the Russian situation – are still very bullish. If the 260,000 ounces of Russian supply would appear and be added to this year's supply, it would indeed ease the pressure on the production/consumption deficit. However, even if the Russians had provided the market with all their (assumed) available platinum, new supply for 1999 would still have been lower than the previous year. In fact, aside from 1998 when global output growth spurted to 5.4 million ounces, it has been flat since 1995 at about 4.9 million ounces. Demand, on the other hand has been growing steadily throughout the decade at about 4.5% per annum.

South African production will increase by about 1 million ounces this year, but it should all be easily absorbed. Demand is increasing on all fronts. In fact, the recent surge to fresh multi-month highs came on news that the US Environmental Protection Agency proposed standards that would cut 97% of sulphur burned in diesel fuel in large trucks and buses. General Motors Corp. promptly announced that it would use 10% more platinum in catalysts by the year 2002.

The trend of declining use of platinum in autocatalysts began because of the increased use of palladium as a catalyst. But as we've pointed out in previous articles on platinum, this switch-over is likely to reverse, because the development of

commercially viable palladium catalysts was inspired by its price advantage. Now that palladium prices seem to be maintaining this new price level which has grown by 400% since the technology blossomed, the advantage is gone (Chart 3). Our research indicates that although there are retooling and legal issues involved, switching back and forth between the technologies that are most cost efficient is not a very big deal, and is well worth the effort.

Demand from the jewelry industry continues to boom and now comprises over 50% of total consumption. Global jewelry consumption in 1999, grew by 450,000 ounces, or 18%, easily compensating for the 190,000-ounce loss in demand for autocatalysts.

A whole new area of demand for platinum is the budding fuel cell industry. The fuel cell is the next generation technology for electricity generation and a viable alternative to the combustion engine. Platinum is used as the catalyst in fuel cells and is one of the vital components of the technology. At the moment, the technology is not available on a widespread commercial basis. However, it is a proven technology and will turn up at the consumer level soon enough. Just last week, Johnson & Matthey signed an agreement with a British manufacturer to market fuel cell technology.

The Chinese government has legislated the use of autocatalysts, which will be phased in over the next few years to meet European standards by the year 2004. Although it would be difficult to quantify, we can let our imaginations run wild. We're dealing with a country with an untapped market and a population of over 1.2 billion people.

Evidence that the lofty prices are being generated by genuine industrial demand, as opposed to speculation that will disappear as fast as it came, comes from a glance at the open interest. In both markets – the New York Mercantile Exchange (Chart 4) and the Tokyo Commodity Exchange (Chart 5) – open interest is as low as it's been in years. This market has not run out of steam yet. *[May 22, 2000]*

**CURRENT STRATEGY:** Remain long July platinum as per Flash Update of May 3. Raise stops to 470, close only.

Chart 2 – July Platinum



Chart 3 – Monthly Palladium

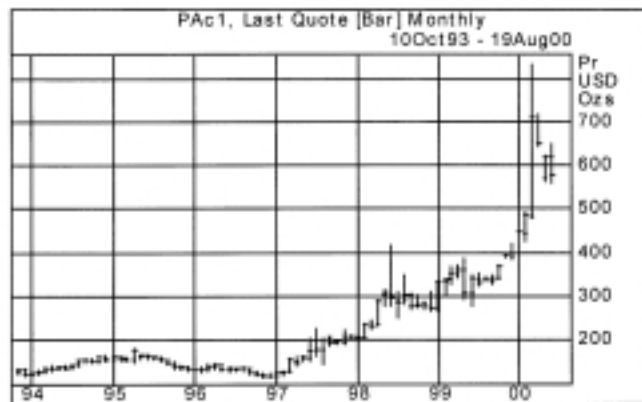


Chart 3

Platinum open interest at the New York Mercantile Exchange

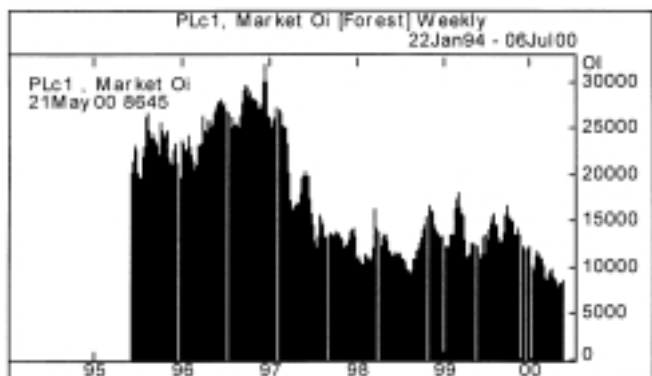
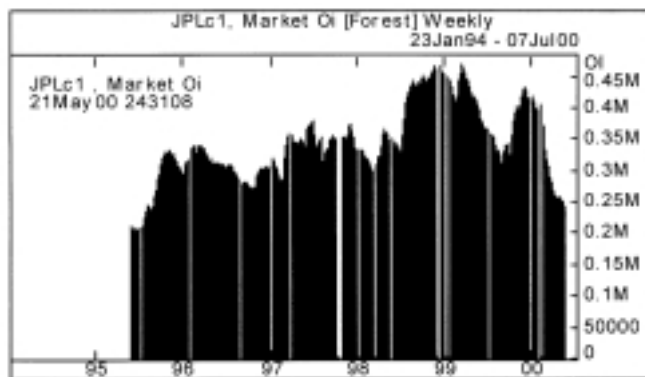


Chart 4

Platinum open interest at the Tokyo Commodity Exchange



Charts courtesy of Reuters

## WHEAT

# Will falling production usher in a bull market?

Earlier this year, when grain prices began to crawl out of the cellar, the wheat market participated in the rally. It soon became obvious, though, that wheat was riding the coattails of corn and soybeans and did not have the legs to match last summer's peak the way corn and bean prices did. Indeed, July wheat came all the way back to make a new low at the end of April. Since then, however, wheat has shot up by over 30¢ per bushel, which was accomplished even while corn and beans suffered a sharp setback when significant rains began to replenish subsoil moisture levels in the Midwest.

The strong prices have little to do with current developments in the US. On the contrary, if we were to focus on the US scene, we'd find supply and demand fundamentals that are neutral to slightly negative for prices. Export demand has been sluggish. Export commitments (old crop year plus new crop year) have declined steadily since February.

By breaking export commitments into four-week segments (Table 1), we get a snapshot of the trend. There was a brief flurry of robust export activity after a disastrous holiday season. That period, however, was indeed brief, and even declining prices failed to inspire much demand for US wheat.

Table 1

REPORTING PERIOD	AVERAGE WEEKLY COMMITMENTS (TONNES)
April 27 - May 18	399000
March 30 - April 20	409000
March 2 -March 23	427000
February 3 - February 25	592000
January 7 - January 28	227000

The USDA estimates that the US will export 1.075 billion bushels of wheat in the 1999-00 marketing year. This would be above last year's level of 1.042 billion bushels, but the comparison is a bit misleading. Total commitments for the 1999-00 crop year, which ends May 31, currently stand at 966 million bushels and will almost certainly finish the year below 1 billion bushels.

There is no mystery here, because the 1.075 billion bushel figure includes government and other groups' relief donations. While the USDA's 1.075 billion bushel estimate is crucial in arriving at an accurate figure for ending stocks, it should be pointed out that donations are not necessarily recurring and do not give a fair representation of the trend of commercial demand.

Although the spring wheat crop represents only 25% of the total crop, success or failure in the extreme could be significant. The most recent crop progress report, released on May 22, shows that, if anything, the former is a more likely scenario. In the six states that grow 98% of all US spring wheat, 95% of the crop has been planted. This compares with 69% at the same time last year, and the five-year average of 70%. Of the wheat that has been planted, 82% has emerged compared with 49% last year, and the five-year average of 46%. The earlier the crop gets on its way before the summer's most vulnerable hot and dry weather period, the more resilient it will be if we were to encounter weather problems.

So why do wheat prices continue to be the star performer in the futures pits of the Chicago Board of Trade even as corn and bean prices are sagging (Chart 6)? The

answer is found in the May 12 USDA supply/demand situation report. The report confirms that the trend of slumping global production in an environment of steady growth in consumption persists.

Output for the 2000-01 season will fall to 580 million tonnes from 587 million tonnes this past season. This marks the third year of lower crops. Consumption is estimated to be fairly constant at 596 million tonnes. But, ending stocks will drop sharply to 109 million tonnes from 126 million tonnes at the end of the 1999-00 season. This will be the lowest level of stocks since 1996 when wheat prices soared to over \$7 per bushel. That seems bullish enough. But when measured in terms of the stocks-to-consumption ratio, we are looking at the tightest supply situation in decades. Global ending stocks as a percentage of global consumption will fall to 18.3% from 21% in 1999-00. At the end of the \$7-per-bushel 1995-96 season, ending stocks were 19.6% of consumption.

Looking at some of the component countries, we find output in the European Union will jump by 9 million tonnes, or 10%, in 2000-01, but that's where the output growth ends. Significant exporters like Australia and Canada will have smaller crops. Between the two they will

produce about 3.5 million tonnes less than last year. The big loss in output comes from China where much acreage was switched to oilseed production. Production is estimated to drop by 8 million tonnes to 107 million tonnes. Ending stocks in China have been dropping steadily since 1997-98 when they were 28.8% of consumption. According to the fresh USDA data, Chinese ending stocks will end the 2000-01 season at 17.6% of consumption.

All this assumes stagnant consumption, which is a fair assumption, especially considering the limp export trade we illustrated above. Bill Gary of *Price Perceptions* (May 20), however, points out that "world wheat demand has increased in 21 of the past 25 years.....our studies point to a slight increase of 2.5 million tonnes."

We believe that the case is quite simple. Current prices, still so near their multi-year lows (Chart 7), are nowhere near a fair representation of the tightening world supply/demand balance. This is a bull market in its infancy.

[May 24, 2000]

**STRATEGY:** Buy July wheat as per Flash Update of May 23. Place initial stops at 267, close only.

Chart 6 – Wheat/Corn Ratio



Charts courtesy of Reuters

Chart 7 – Monthly Wheat



**POST MORTEM****Corn and Canadian dollar****Corn**

The corn market is playing the hand it was dealt. July corn has plummeted by 30¢ per bushel from its peak early this month. Drought fears were allayed when the Midwest started to get some rain. A very successful spring planting campaign means that the crop will be well developed earlier and thus more resilient to a potentially hot, dry summer. To illustrate, consider that as of May 21, 96% of the crop was planted. This compares with 84% planted at the same time last year, and the five-year average of 77%. A total of 84% of the corn crop has emerged compared with 51% this time last year. The precipitation and the progress of the crop certainly gives some credibility to the USDA's estimate of a 9.74 billion bushel crop for the 2000-01 season.

The demand side is somewhat soggy as well. After a strong April, export sales tapered off in May. Average weekly sales (old crop plus new crop) in the past four weeks were 785,000 tonnes compared with 1.012 million tonnes in the previous four-week period. In its May 12 report the USDA lowered its estimate for 1999-00 exports again to 47.63 tonnes (1.875 billion bushels) from 48.26 tonnes (1.9 billion bushels) to reflect the slackened foreign interest in US corn.

If all goes well with the crop, there is little reason to be long a corn market that is projected to end the 2000-01 season with carryover stocks of close to 2 billion bushels. These carryover stocks are 200 million bushels higher than those at the end of the 1999-00 season and represent 25% of consumption compared with last season's 23.5%.

Nevertheless, we have not abandoned the notion of being long this market completely. The weather premium is gone. Some analysts feel that the USDA was a bit overzealous in calling for a yield of 137 bushels per acre. This would be 3.2 bushels per acre higher than last year and the second-highest yield on record. Although the rains were obviously helpful, the dry conditions began many months ago and it would be premature to declare the dry subsoil moisture conditions to be out of the woods completely. By projecting such a bountiful crop, the USDA left little room for disappointing weather that might lower yields.

The USDA raised its forecast for global ending stocks for 2000-01 by 6 million tonnes to 119 million tonnes, or

19.5% of consumption. This compares with 18.7% at the end of the current season. Consumption is estimated to be 6 million tonnes higher, so the increase in stocks all revolves around the anticipated 7.6 million-tonne increase in the US crop. Which is fine if the weatherman continues to cooperate. If he doesn't, we will be back.

**STRATEGY:** *Remain sidelined, but stay tuned.*

**Canadian dollar**

The performance of the Canadian dollar throughout the 1990s earned the currency some unfriendly nicknames, such as the Canadian peso. Although the southernmost part of Canada is a three-hour flight to the nearest tropical grove, each fresh plunge in the currency saw the country ridiculed in the press as a banana republic.

The currency hit rock bottom in the summer of 1989 when it briefly touched US63.2¢. From that point, it began a recovery that would last until early this year when it attempted – unsuccessfully – to pierce the US70¢ level. During this period, it was widely believed that the primary issue to plague the currency was weak commodity markets. The market kept driving the currency down in search of a remedy to this problem by increasing revenues to Canadian exporters to compensate for revenue lost to those falling commodity prices. After all, the export sector makes up such a huge part of Canadian GDP and as such is vital to the economy.

For a long time, it certainly seemed that this analysis was accurate. The merchandise trade surplus snapped out of a slump that dated back to 1996. The surplus grew steadily from a low of less than \$1 billion to where it stands now at \$3.9 billion. Commodity prices staged an impressive recovery. The Bridge/CRB Index is up 23% from its lows. The prices of principal Canadian exports such as pulp and natural gas are soaring. Given these conditions, the currency is surprisingly weak. Since the end of January, it has dropped roughly half the gains it achieved in the previous 12 months. The two other currencies that are billed as commodity currencies, the Australian and New Zealand dollars, are in a freefall as well, despite the improved commodity fundamentals.

The current account, which includes merchandise

trade, has improved dramatically as well during this period. At the end of 1997, it stood at a deficit of close to \$8 billion. By the end of Q3 1999, it had recovered and had crossed the line of respectability by registering a small surplus. That was short-lived, however. By the end of Q4 1999, the latest reporting period, the current account had retreated to deficit territory, registering the largest quarterly drop since its recovery began.

We feel that the wide gap – 86 basis points – between US and Canadian short-term interest rates is largely to blame for the currency's renewed downtrend. Despite the Bank of

Canada's success in exercising its official vigilant policy of maintaining a 1% to 3% core inflation rate, foreigners obviously perceive the bank as soft. With the core inflation rate coming in last month at a lower-than-expected 1.3% per annum and comfortably away from the top end of the target band, there is no chance that the Bank of Canada will be any more aggressive than the Fed. That leaves no hope that the spread in short-term rates will narrow in the foreseeable future.

*[May 28, 2000]*

**STRATEGY:** *Remained sidelined.*

## HOTLINE UPDATE

**Flash Update: Tuesday, May 2, 2000:**

Good morning for Tuesday, May 2, 9:15 am. This is a Flash Update. We have purchased July cocoa at 804, placing our initial stop at 744, close only.

**Flash Update: Tuesday, May 2, 2000:**

Good afternoon for Tuesday, May 2, 12:15 pm. This is a Flash Update. We have liquidated our long June Canadian dollar position at .6738. We repeat our Flash Update from this morning where we purchased July cocoa at 804, placing our initial stop at 744, close only.

**Flash Update: Wednesday, May 3, 2000:**

Good morning for Friday, May 3, 9:10 am. This is a Flash Update. We have purchased July platinum at 471, placing our initial stop at 443.5, close only.

**Friday, May 5, 2000:**

Good afternoon for Friday, May 5, 5:20 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are

- Long July sugar, with our stop revised to 6.10.
- Long July corn, with our stop at 228.
- Long June CRB Index, with our stop revised to 209.
- Long July cocoa, with our initial stop at 744.
- Long July platinum, with our initial stop at 443.50.

All stops are close only.

**Friday, May 12, 2000:**

Good afternoon for Friday, May 12, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are

- Long July sugar, with our stop at 6.10.

- Long July corn, with our stop at 228.
  - Long June CRB Index, with our stop at 209.
  - Long July cocoa, with our stop at 744.
  - Long July platinum, with our stop at 443.50.
- All stops are close only.

**Friday, May 19, 2000:**

Good afternoon for Friday, May 19, 4:50 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are

- Long July sugar, with our stop revised to 6.25.
  - Long July corn, with our stop at 228.
  - Long June CRB Index, with our stop at 209.
  - Long July cocoa, with our stop revised to 770.
  - Long July platinum, with our stop at 443.50.
- All stops are close only.

**Flash Update: Tuesday, May 23, 2000:**

Good morning for Tuesday May 23, 11:20 am. This is a flash update. We have liquidated our long July corn positions at 239 3/4, and purchased July Wheat at 282 1/2, placing our initial stop at 267 close only.

**Friday, May 26, 2000:**

Good afternoon for Friday, May 26, 4:30 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are

- Long July sugar, with our stop revised to 6.80.
  - Long June CRB Index, with our stop revised to 216.
  - Long July cocoa, with our stop at 770.
  - Long July platinum, with our stop revised to 470.
  - Long July wheat, with our initial stop at 267.
- All stops are close only.

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**Subscription Enquiries for**  
Friedberg's Focus on Futures  
P.O. Box 866, Suite 250  
BCE Place, 181 Bay Street  
Toronto, Ontario, Canada  
M5J 2T3  
(416) 364-1171

**All enquiries concerning trading accounts should be directed to:**  
**In Canada**  
Friedberg Mercantile Group  
P.O. Box 866, Suite 250  
BCE Place, 181 Bay Street  
Toronto, Ontario M5J 2T3  
(416) 350-2903  
Attn: Sholom Sanik

**In U.S.**  
Friedberg Mercantile Group Inc.  
67 Wall St., Suite 1901  
New York, N.Y. 10005  
(212) 943-5300

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