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Sugar: large inventories?

Sugar traders are considering the two variables that could set the trend of sugar prices in the foreseeable future: Chinese imports and the size of the 2001-02 Brazilian crop. Although it could be months before the results of either of these issues will be clear, recent developments in both areas have been bullish.

Last week, the USDA attaché in Brazil estimated that sugarcane production for 2001-02 would increase by 6.4% over last season. A few months ago we saw forecasts that called for an increase of about 15%. This is the smallest estimate we've seen thus far. Despite the larger crop, the amount of sugar available for export will drop this year – from 7.7 million tonnes to 6.9 million tonnes – because by May 1, the government is expected to increase the ratio of anhydrous alcohol to gasoline in motor fuel to 24% from 20%.

The official line of the Chinese government has been to downplay the amount it intends to import this year. This is understandable, because analysts have not been ambiguous in connecting robust Chinese imports to higher prices. It was quite interesting, then, when the Chinese government released a report the other day that pegged the 2000-01 crop size at 6.02 million tonnes, lower than its previous estimate and the lowest estimate to date by any of the major analysts. With consumption for 2000-01 estimated at over 8 million tonnes, the Chinese would have to deplete all their inventories – about 1.5 million tonnes – to keep from importing at the high end of analysts' estimates.

When presenting the bearish case for sugar, analysts frequently refer to the burdensome global carryover stocks that represent 43% of consumption. However, citing this statistic without looking at the components is a bit of a misrepresentation. India, for example, owns the world's largest inventory of sugar – about 11 million tonnes. This figure distorts the true ending-stocks picture, because there is not a whole lot that India can do with this stockpile anyway. A complicated bureaucracy keeps Indians from exporting more than 1 mil-

lion tonnes a year. By removing Indian ending stocks from the world total, we find stocks as a percentage of consumption to be no more than 35%.

Of course, even 35% is quite high. But the point is that comparing the level of sugar stocks with that of other commodities that carry stocks closer to 20% of consumption is misleading. We don't know how much sugar can be mobilized from stocks for the export market. The evidence lies in the events of this past year. Global ending stocks for 1999-00 were 47% of consumption. The combination of poor crops in Brazil and the EU and a continuation of trendline consumption patterns saw global ending stocks drop to 43% of con-

In this issue

- 2 Special Report**
The Fed has lost all credibility
- 4 Cocoa**
The correction is over, the bull is back
- 5 Copper**
The bear takes a break
- 6 Wheat**
A shrinking US wheat crop is chasing the bear away
- 8 Hotline Update**

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sumption in 2000-01. That's still very high when measured by the standards of other agricultural commodities. Still, a drop of 4 percentage points in the stocks-to-consumption ratio was enough of a drawdown in world inventories to propel sugar prices into a spectacular bull market.

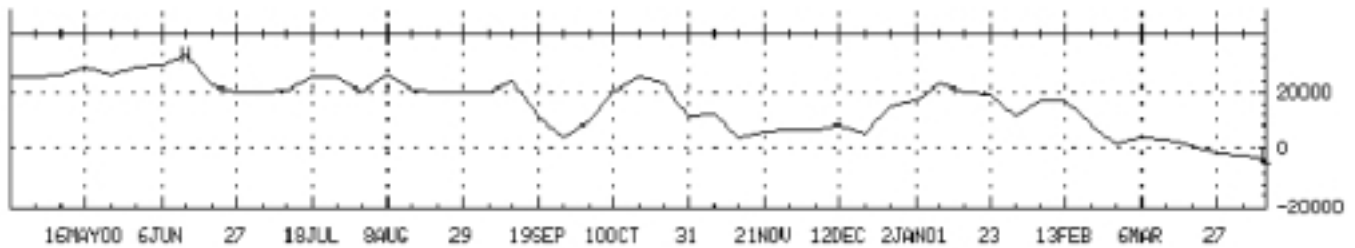
As far as timing is concerned, we believe that a resumption of the bull market is close at hand. Most analysts explain the recent price weakness in terms of deteriorating fundamentals. We definitely agree that the production/consumption balance has improved since the first estimates of a 5-million-tonne deficit were predicted way down at the bottom of the market, about a year ago. It can be argued, however, that much of the weakness we've seen since the market peaked this past fall was exaggerated by an extremely lopsided short position initiated by speculators, both large and small.

Sugar is typically a favorite of the small speculator – the long side that is. At this time, though, they hold a rare net short position of 3,230 contracts (Chart 1). The last time the small speculator section was net short sugar was in February 2000, right at the bottom of the market. Commodity funds are heavily short – short 31,098 contracts against long positions of only 6,392 contracts.

We don't know how much sugar China will buy this year, and the size of the Brazilian crop is still up in the air. As illustrated, however, both are pointing in a bullish direction. We feel comfortable placing a bet with commercial traders who own the net long side of the trade. *[April 20, 2001]*

CURRENT STRATEGY: Buy July sugar as per Flash Update of April 20. Raise stops to 7.95, close only.

Chart 1 – Net Sugar Positions of Small Speculators



Courtesy of Bloomberg

SPECIAL REPORT

The Fed has lost all credibility

This article originally appeared in the National Post, April 30, 2001

This month's surprise 50-basis-point cut from the voting members of the Federal Reserve's Federal Open Market Committee (FOMC) came from the same regional presidents that had uniformly presented a rosy view of economic prospects. Consider the following: On April 12, a mere six days earlier, Thomas Hoenig, the president of the Federal Reserve of Kansas City and a voting member of the FOMC, said that there were signs that the US economy had stabilized and that growth would likely rebound in coming months as excess inventories cleared up and spending picked up. He indicated that growth of 1% at an annual rate in the first quarter is a "very rea-

sonable number," and that the second quarter will also be "relatively slow, maybe 1% growth." After that, he added, the economy will pick up and move back to the 2% range, and by the end of the year growth should "move past 2.5% to 3%, if all goes well."

Other regional presidents offered much the same view. This august body, collectively, then changed its mind within less than a fortnight, with nary a pip of dissent.

What exceptional circumstances were present on April 18 – and not in the weeks immediately preceding – that justified an inter-meeting 50-basis-point cut in rates,

let alone one announced in the middle of the trading day, causing huge dislocations in otherwise perfectly functioning markets? How will those who sold shares just prior to the announcement feel?

Modern finance has embraced the idea that a central bank's best measure of success is its ability to guide markets in their desired direction. In effect, the ideal central bank ought to be able to act without measurably affecting markets. This view has been propounded by the Bank of England and, more recently, by St. Louis Fed president William Poole in an April 2000 working paper (co-authored with Robert H. Rasche, its senior vice-president and director of research): "We argue that monetary policy should be conducted in such a way that the market can predict policy actions...[T]he failure of the market to predict policy actions reflects a problem that needs to be addressed."

But how can the market predict policy actions when this very same FOMC member, along with all his colleagues, told us in recent weeks that the economy was still expanding, albeit at a slow pace, and that growth would pick up significantly in the second half of the year?

The Fed-speak was so effective that by April 18, the April Fed Funds futures contract had expunged any trace of an expected ease for the month (trading at the equivalent of 5% and in line with the then current Fed Funds rate). The May contract, spanning the May 15 Fed meeting (and which was widely expected to deliver some easing), traded to show a yield of 4.85%. Since the contract settles at the average Fed Funds rate for the month, the 4.85% rate indicated a belief that the Fed would lower the rate by 30 basis points, or, more tellingly, that there was a 60% chance of a 50-basis-point cut at the scheduled May 15 meeting.

The 50-basis-point inter-meeting cut, was not a surprise. It was a bombshell. Is this the way, Mr. Poole, responsible and sophisticated central banks act?

A legitimate case could have been made for a further cut in rates. Where we disagree is with the manner, timing and rationale of its execution. The argument should have been based solely on monetary grounds, as befits a central bank charged with the conduct of monetary

policy. For example, it could have noted that the short end of the yield curve was still inconveniently inverted (causing, among other things, a contraction in the rate of growth of bank reserves), a classic concern for any central bank once a boom has effectively been burst. Instead, the Fed noted the softness of capital spending, possible effects of earlier reductions in equity wealth and the risk of slower growth abroad – all non-monetary and highly speculative concerns. Finally, as befits a responsible central bank, the Fed should have balanced its remarks by noting that inflation was becoming a problem and that further rate cuts were in jeopardy. Indeed, over the past three months, consumer prices, ex energy and food, have accelerated to a 3.5% annual rate, the highest rate since early 1995. Incredibly, the statement released by the FOMC did not make a single mention of inflation.

The US Federal Reserve has lost its way – pressured and cajoled by public opinion, operating a woefully deficient monetary regime, unable to divine the future, let alone the next morrow. Guided by mortals like you and me, what can we expect of it? Worse than little. Booms and busts, asset deflation and price inflation, massive taxpayer-financed bail-outs, meaningless (and misleading) speeches. In short, deception that leads to the destruction of private savings.

The Fed, by its own rules, has lost, in our opinion, all credibility. That credibility began to erode in the Great Inflation of the '70s, withered further in the events leading to and in the aftermath of the '87 crash, continued to wear away with the S&L fiasco, the Mexican, East Asian, Russian and LTCM bailouts, and collapsed with its most recent and blatant attempt to protect US investors from their follies.

The European Central Bank, firmly focused on inflation, stands in sharp contrast to the populist, opaque and double-talking Fed. We expect foreign exchange markets to soon deliver their verdict and mount a formidable attack on the US currency.

– *A.D.F.*

COCOA**The correction is over, the bull is back**

Late last year, when enough cocoa beans had arrived at Ivorian ports to make year-over-year comparisons meaningful, it became clear that crop size in the world's largest producer would not continue to expand indefinitely. Early estimates for 2000-01 output called for a crop that would be some 350,000 tonnes smaller than the previous season, a drop of 20%. In the space of 2 months, prices rocketed to \$1,200 per tonne from multi-year lows of below \$700 per tonne. Since the market peaked in February, however, the market has shed \$250 per tonne, or about half of the extraordinary gains. Has the bear returned to the cocoa market, or are we merely experiencing a correction in a long-term bull market?

The roots of the strength in cocoa prices are found in the structural changes that have taken place in the cocoa industry in the Ivory Coast. The government's abandonment of the decades-old marketing board that allowed the cocoa industry to flourish in the first place has stripped farmers of the confidence they need to invest in their plantations. Even if prices do remain strong, it is highly unlikely that we will ever see the kind of crops that were grown in the past five years. That is the macro picture. But is the current pullback in prices the spot to get back on the long side?

Well-regarded analyst E.D.&F. Man tempered the bullish contingent's optimism in its March 13 report with more moderate forecasts for both the supply and demand sides. It estimated Ivorian production would be only 250,000 tonnes less than last year. Even more disappointing to bulls was news that it expected no growth in grindings for the 2000-01 season, after 8% growth in 1999-00.

The main-crop arrival season is in the books. However, the ambiguity about its size seems to have provided some support this past month at the \$950 per tonne level. The most recent estimate was released by the Ivorian Agriculture Ministry on April 12. It claims that the main-crop was no bigger than 910,000 tonnes, 70,000 tonnes below Man's estimate. Now, traders are waiting to see how the mid-crop will look. The ministry estimates that it will not reach more than 150,000 tonnes, which is close to 50,000 tonnes less than previous estimates.

One area that is becoming somewhat clearer is grinding

activity. First-quarter results are in. They show Man's call for a flat rate of growth to have been somewhat pessimistic. The only country with lower grindings compared with first quarter 2000 was Brazil, which reported a fall of 9%, to 45,961 tonnes. Aside from Brazil, other results were generally better than expected by the trade. The US grind was up 3.1%, to 113,734 tonnes. The Pan-European grind totaled 184,411 tonnes, 3% higher than the first quarter of 2000. Even after including the poor Brazilian figures, the reported grinds were up 1.25% collectively.

These figures do not include grindings in origin countries whose grinding capacity has grown rapidly over the past few years. European chocolate manufacturers have been finding it more economical to grind the beans locally and ship the products. They have invested in processing facilities in all the origin countries. This is particularly true in Ivory Coast and Ghana, the world's two largest producers. Accurate figures are not available, but it is certain grindings have increased each year since this trend began, and this year will be no different. Despite this strategic shift, we are still seeing small increases in the traditional grinding countries, which flies in the face of Man's prediction that we will see no growth at all this year. We have only the first quarter behind us, but it's not a bad start.

The fundamentals that kept cocoa in a bear market for so many years have changed dramatically. Still, the huge rally that we saw early this year was in no small part a consequence of a ridiculously large open interest that consisted of a lopsided net short position by commodity funds. All lopsided positions have to be covered eventually. The rally was accompanied by a drop in open interest of about 50,000 contracts, during which the funds swung completely to a flat position (they were net long for one weekly reporting period).

The point of all this is that they're at it again, building a short position. We believe, as illustrated, that the fundamentals are bullish and that the ensuing rally will be intensified when the shorts are forced to cover. *[April 24, 2001].*

STRATEGY: Buy July cocoa as per Flash Update of April 20. Place initial stops at 9.30, close only.

COPPER**The bear takes a break**

Copper traders have not shared the recent enthusiasm felt by stock market participants. On the surface one would think that copper was oversold. Looking at global production/consumption balances, we find a deficit for 2000, and analysts are still forecasting the same for 2001. The weakness in copper that began last summer, then, was in *anticipation* of falling demand that would surely arrive once the economy was firmly in the grip of the slowdown.

Copper prices have tracked the stock market closely over the past year and a half or so. Although copper prices seem to have moved up along with the current bounce in the stock market (see Chart 2), it's been a lame rally. Even after stocks backed off their highs, the S&P 500 is still up a formidable 10% from its lows. May copper is about 1.5¢ per pound off its lows. We did manage a 2¢ per pound rally on the day of the surprise 50-basis-point cut in the Federal Funds rate, but those gains have vanished.

To explain the weakness, we must understand that forecasts for large deficits are not realistic from here on in, because those forecasts have not accounted for a drop in consumption. According to The International Copper Study Group (ICSG), global copper consumption in 2000 grew by 7.5% over 1999. It is unlikely that we will be able to maintain that kind of growth in 2001. ICSG reported a supply/demand surplus in each of the past three monthly reporting periods. The two most recent periods showed particularly weak demand, with surpluses of 149,000 tonnes for December and 111,000 tonnes for January. Unless demand picks up significantly, it is difficult to see how we would end up with a deficit similar to this past year's.

After years of rapid growth in production, output has slowed down in the past two years, contributing to the deficits. During the first half of 2000, production was growing at a rate of about 2% per annum, but picked up in the latter part of the year to finish with an increase of 3.1% over 1999. The most recent figures support the view that this trend is continuing. With production for January at 1.33 million tonnes, output was 4% higher than January 2000. This is

especially interesting when compared with consumption of 1.22 million tonnes in January, which was only 2.4% higher than last January.

Soaring energy prices have increased production costs for mining companies and have raised fears that mine closures would become a significant factor. Indeed, there have been cutbacks but not as many and not as large as might have been expected by now. Phelps Dodge, for example, disappointed bulls at the end of March by announcing that it would reduce output by 80,000 tonnes a year, which was below the low end of analysts' expectations. The street was looking for cuts of anywhere between 150,000 and 300,000 tonnes.

To digress for a moment, natural gas and crude oil prices are much higher than they were two years ago. Both, however, have stabilized. In the past couple of months, natural gas has been trading between \$5 and \$5.5 per mMBTU and crude oil between \$26 and \$29 per barrel. Perhaps this had something to do with Phelps Dodge cutting back only a token amount of output and is the reason we haven't seen other cutbacks. Besides, many mines – such as those in Chile and Indonesia – can still produce copper at very low cost. Last week, Freeport McMoRan reported its first-quarter results and indicated that cash costs in 2001 dropped to 35¢ per pound from 41¢ in 2000.

Inventories are piling up at LME warehouses, having risen 100,000 tonnes to 440,000 tonnes in just the past 6 weeks. The contango for both COMEX and LME prices has moved to its widest level in many months, indicating clearly that there is very little urgency among consumers.

The latest commitment of traders report points to a classic bear trap setup, with commodity funds heavily short and commercial traders on the long side. Despite our bearish leanings, we anticipate a significant short-covering rally at some point and therefore took the preemptive measure of covering our short position. We look to re-enter the short side when the threat of a countertrend rally diminishes. [April 25, 2001].

STRATEGY: *Cover short copper positions as per Flash Update of April 19. Stay tuned.*

Chart 2 – May Copper



Courtesy of REUTERS

WHEAT

A shrinking US wheat crop is chasing the bear away

Well, here we go again with another rally in wheat. Is there more substance this time around than previous stabs at the \$3-per-bushel level?

It's the time of year when wheat traders turn their attention to the progress of the US winter wheat crop – so important because it represents about 70% of the total US crop. July wheat has firmed by 18¢ per bushel after touching a contract low of \$2.66 at the end of March. The rally was inspired by reports that inclement weather conditions in key winter wheat regions would cause lower yields and – in some cases – abandonment. Unfavorable weather conditions that may result in a disappointing harvest are of particular concern this year because, as it is, the winter wheat crop that was planted last fall was the smallest in three decades.

In this past Monday's weekly crop progress report, the USDA reported that the good-to-excellent portion of the

crop dropped a notch from the previous week, to 44% of the total. This compares with a 61% rating for the top category at this juncture of the 2000-01 season. The very-poor-to-poor section jumped to 22% compared with only 14% last year.

To illustrate the potential effect on ending stocks more specifically, consider the following statistics. In the 2000-01 season, Kansas, the biggest wheat producing state, harvested 348 million bushels of wheat, which was close to 16% of the total US crop. Even in global terms its output is meaningful at 1.6% of the total. On Tuesday, highly regarded Kansas State University (KSU) agronomist Bill Tierney provided the market with a damage assessment. He estimated that Kansas farmers would harvest only 289 million bushels of wheat in 2001-02, 59 million bushels less than last year. Another agronomist with KSU offered a bleaker estimate, forecasting that the crop could be as

small as 225 million bushels.

The resulting smaller crop will cause a material impact on the US balance sheet. Based on planting intentions, the 2001-02 US crop will be about 3.5% smaller than last year (60.3 million acres vs. 62.53 million acres), or about 2.15 billion bushels, before even looking at the damage caused by the weather. Adding in beginning stocks of 829 million bushels and miscellaneous supplies of about 100 million bushels gives us total supplies of 3.08 billion bushels. If we assume consumption will be similar to last year at 2.43 billion bushels, 2001-02 ending stocks will be 644 million bushels, or 26% of consumption, the smallest since the 1996-97 season.

This is a very conservative estimate that assumes only an 80 million bushel drop in production. Bill Tierney told us just this afternoon that after accounting for the damage to the winter wheat and the poor planting season we're currently experiencing for spring wheat, it is not unreasonable to expect a 200 million bushel drop in the total crop. This would put available supplies at about 2.96 billion bushels, leaving a 2001-02 carryover of 526 million bushels, or 21% of consumption. This, of course, would be a vastly different configuration than the current carryover of 829 million bushels, or 34% of consumption.

Ultimately, the wheat market's inability to mount any

lasting rallies can be traced back to burdensome US supplies, which can be traced to a strong dollar. The dollar seems to have stabilized (we actually have a rather bearish bias, see *Focus on Futures*, April 20) but probably not enough to cure that particular ill. Export commitments have averaged 325,000 tonnes over the past 4 weeks – a very disappointing performance. To reach the USDA's estimate for annual exports of 29.94 million tonnes, we would need to see weekly commitments of close to 650,000 tonnes.

Interestingly enough, despite the lame business climate, we have not fallen behind last year's pace. In fact, this week's figure pushed us ahead of last year's commitments by 400,000 tonnes, and we still managed to reach 29.65 million tonnes in exports last year.

In conclusion, even if US export business were to remain flat, the adverse weather in the winter wheat states could likely – as illustrated – bring US inventories into line with the tight global picture. As with most other commodities, the funds are heavily short and will have to run for cover if bullish fundamentals overwhelm them. We are waiting patiently, but definitely looking to the long side. Keep posted.

[April 26, 2001].

STRATEGY: *Stay tuned.*

HOTLINE UPDATE

Friday, April 6, 2001:

Good afternoon for Friday, April 6, 4:15 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are short May copper, with our stop at 81.00, and short July platinum, with our stop at 581. All stops are close only.

Flash Update – Wednesday, April 11, 2001:

Good morning for Wednesday, April 11, 9:45 am. This is a Flash Update. We have covered our short July platinum position at 571.50.

Thursday, April 12, 2001:

Good afternoon for Thursday, April 12, 4:40 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are short May copper, with our stop at 81.00. All stops are close only.

Flash Update – Wednesday, April 18, 2001:

Good morning for Wednesday, April 18, 11:05 am. This is a Flash Update. We have sold short July silver at 4.40, placing our initial stop at 4.54, close only.

Flash Update – Thursday, April 19, 2001:

Good morning for Thursday, April 19, 9:10 am. This is a Flash Update. We have covered our short May copper position at 78.50.

Flash Update – Friday, April 20, 2001:

Good morning for Friday, April 20, 10:10 am. This is a Flash Update. We have purchased July cocoa at 1000, placing our initial stop at 930, and we have purchased July sugar at 8.31, placing our initial stop at 7.45, close only.

Friday, April 20, 2001:

Good afternoon for Friday, April 20, 4:50 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are short July silver, with our initial stop at 455, long July cocoa, with our initial stop at 930, and long July sugar, with our initial stop at 7.45. All stops are close only.

Friday, April 27, 2001:

Good afternoon for Friday, April 27, 4:50 pm. The following is a recap of our current open position recommendations and our latest stop levels. We are short July silver, with our stop at 455, long July cocoa, with our stop at 930, and long July sugar, with our stop revised to 7.95. All stops are close only.

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