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The cotton bear heads into hibernation

The May USDA supply/demand situation report cast a whole new light on the cotton market with an outlook for 2002-03 dramatically different from the 2001-02 season. Although no items in the report were especially shocking in that they were in line with expectations, the report serves as confirmation that things are changing in this market.

US cotton acreage will be 1 million acres less than last year. Using 10-year average abandonment rates and yields of 640 pounds per harvested acre, the US will produce 17.8 million bales, 2.5 million bales less than last year's 20.3-million bale crop. The average of analysts' estimates was 17.9 million bales.

Foreign production is forecast to drop 4.45 million bales, to 73.2 million bales. The USDA did not provide a breakdown by country, because it is too early in the season. They made some brief observations, though. The disincentive of low prices suggest that cotton area in China could decline by as much as 20%, which would shave about 2.5 million bales from its 2001-02 crop. Indications from other important growing regions, like Uzbekistan and West Africa's Franc Zone, are for smaller plantings as well.

Lower US and foreign production will combine to yield a global crop of 91 million bales in 2002-03, 7 million bales, or 8%, less than last year. Consumption, on the other hand, is expected to expand for a fourth consecutive year, to 95.5 million bales, 2 million bales higher than last season. Ending stocks will fall sharply, to 40.61 million bales, or 42.5% of consumption, compared with stocks of 44.81 million bales at the end of 2001-02, or 48% of consumption. This will be the lowest carryout since the end of the 1995-96 season when stocks stood at 35.82 million bales, or 41.2% of consumption.

Ending stocks have averaged 48% of consumption over the past 5 years and 38% of consumption over the previous five-year period. A glance at Chart 1 would seem to confirm that the higher inventory levels were consistent with declining prices, while lower inventories were consistent with the bull market we saw during the first half of the 1990s. At 42.5% of consumption, we're somewhere in the middle.

Although US domestic consumption fell over the past couple of seasons from an average of 10 million bales to 7.6 million bales in 2001-02, it was not the problem it was made out to be by the press. The dramatic increase in exports easily compensated for lackluster domestic consumption. In fact, in combining exports and domestic mill usage, we find total consumption of US cotton actually increased in 2001-02 to 18.6 million bales from 15.62 million bales in 2000-01.

A note on exports: The torrid pace of US export sales has not abated, which prompted the USDA to raise its estimate for annual exports in this month's report by 500,000 bales, to 11 million bales. With this past week's sales report, export commitments have now jumped ahead of the 11-million-bale mark, out of which 8.7 million bales have been shipped. To meet the USDA target, exporters would have to ship an average of 190,000 bales each week for the remaining 12 weeks of the season, which is below the recent average of over 200,000 bales per week.

The USDA is looking for the trend to continue, with its forecast for annual exports of 11 million bales to be repeated in 2002-03.

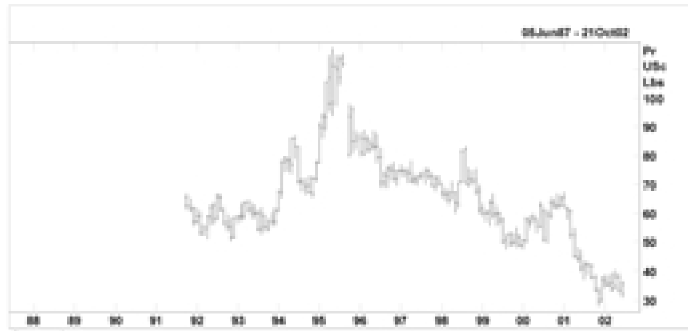
In this issue

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

And as mentioned earlier, global consumption continued to grow throughout the bear market. Thus, contrary to the widely held belief that as an industrial commodity, cotton prices suffered solely from the weak economic environment, the bulk of the damage came from the supply side. With new supply expected to be considerably smaller than last season and demand still growing, these prices are beginning to look absurdly cheap.

In conclusion, with global stocks at 42% of consumption, it is not as if we're running out of cotton any time soon. Still, with a rather dramatic shift in the production/consumption balance anticipated for the coming season and prices close to historical lows, the market merits a look from the long side. *[May 17, 2002]*

Chart 1 – Monthly nearest contract cotton



Courtesy Reuters

STRATEGY: *Stay closely tuned.*

CORN

A sharp drawdown in ending stocks may send the bear packing

The corn market experienced a powerful bull run in the mid-1990s that saw prices skyrocket to over $5 per bushel. Prices have since collapsed and have settled into a relatively narrow 3-year trading range, fluctuating mostly between $2 and $2.20 per bushel.

This month's USDA supply/demand situation report – the first organized set of data for the 2002-03 season – altered the longer-term outlook rather dramatically.

Global production will increase sharply over last year – by 25 million tonnes, or 4.3%, to 615 million tonnes. Consumption will grow by only 10 million tonnes, to 625 million tonnes. Still, the 10-million-tonne gap between new supply and usage will be enough to draw inventories down to multi-decade lows. Ending stocks will fall to 114 million tonnes, or 18.2% of consumption. This compares with ending stocks at the end of this season of 124 million tonnes, or 20.2% of consumption. Average ending stocks for the previous 5 years was 27% of consumption. We'd have to go back a quarter of a century to find stocks at current levels. At the end of the 1975-76 and 1976-77 seasons, stocks stood at 15.9% and 20.15 of consumption, respectively.

Ironically, the 2002-03 crop year will be the closest the market has come to production/consumption balance in several years. The sharp drawdown of ending stocks has been building up gradually, with a 20-million-tonne deficit in 2000-01 and a 26-million-tonne shortfall in 2001-02. With consumption growing at a rate of about 1.6% per annum, it was bound to catch up with the market eventually.

The most recent event that has dominated talk in the corn pits was the appearance of excessively wet weather in the US Midwest, which has hampered planting progress, and is expected to reduce yields. This past Monday's USDA planting-progress report showed that 70% of the crop had been planted, significantly behind schedule when compared with 88% at this juncture last season, and the 87% 5-year average. Prices rallied about 20¢ per bushel when it became clear that seeding would be delayed, the largest rally we've seen in this market since last summer.

Despite the unfriendly planting weather and the drop in ending stocks for the new crop, the strength was short-lived. Prices have retreated back into the confines of the long-standing trading range, casting a market-that-doesn't-respond-to-bullish-news pall over the bull camp.

The estimated 25-million-tonne jump in output comes mainly from expected production increases in the US and China of about 10 million tonnes in each country. We believe that it is a bit early to assume that US crop is going to improve that much over last year when considering the potential impact of planting impediments.

In the May 18 issue of *Price Perceptions*, grain analyst Bill Gary calculates that based on studies of previous years in which corn plantings were similarly late – 1996 and 1999 – US production would be about 6 million tonnes less than the USDA's May estimate. At the same time, he cautions that the wetness would have to persist through to the end of May to have an appreciable impact on prices.

At the time of writing, forecasts were for drier weather. Nevertheless, by the same token that the recent, failed rally overshot the potential impact of bad weather, the more recent setback in prices is probably prematurely discounting the dry weather.

Another issue that has kept prices depressed is

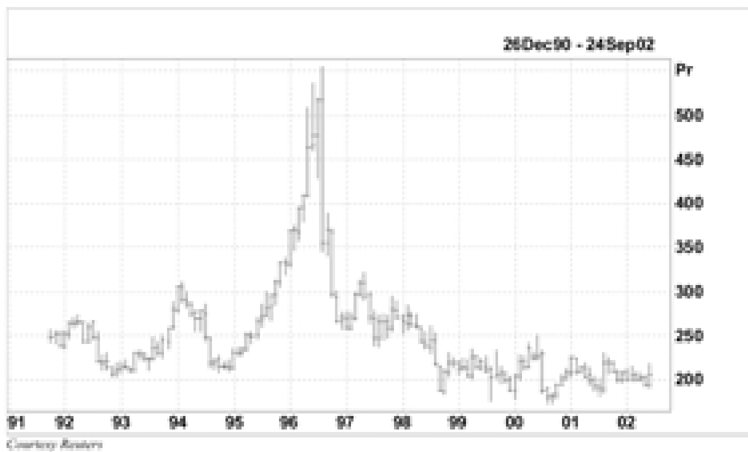
Chinese exports. The USDA estimates that China will export 4 million tonnes of corn this year, down from 6 million tonnes last year. But recent reports suggest that the figure is likely to remain closer to 6 million this year as well. On Thursday, South Korea bought two 50,000-tonne loads of corn from China. While not a huge amount, it clearly had a psychological effect and added to the bearish tone.

In conclusion, we find the picture painted by the USDA for the 2002-03 season more bullish than bearish with the formidable drawdown of global ending stocks. The success of the US planting campaign will be a significant factor for the supply side, and we should keep in mind that the May USDA estimate was based on March planting data, long before there was even a hint of planting delays. The market, however, is focused on all the negatives, which will probably serve to keep prices at bay – for now.

With the market at historically low prices we could envision trading this market from the long side, but remain sidelined. *[May 24, 2002]*

CURRENT STRATEGY: *Purchased December corn as per Flash Update of May 30. Place initial stops at 2.15, close only.*

Chart 2 – Monthly corn



GOLD

Moving with the fundamentals

Gold prices have cleared the February 2000 high of $319 per ounce (Chart 3). The strength is being fueled by a stampede of investors. Press reports tend to pin investors' motivation on the proliferation of geopolitical tensions. We believe that the rally encompasses a far broader range of economic fundamentals.

A read of the open interest confirms that speculators are doing the buying. The current $35-per-ounce leg of the bull run has seen open interest on COMEX jump by some 40,000 contracts, or 35%. During this period, commodity funds added more than 15,000 contracts to their long position to hold 46,914 contracts net long. Small speculators tacked on over 13,000 contracts to their long positions to hold 41,729 contracts net long. The size of the small speculators' position has surpassed the position they held when the market spiked to $417 per ounce in 1996 (Chart 4). The sentiment indicator that we watch is higher than it's been in years. Are we overbought, and should we be expecting a counter-trend correction? Perhaps.

Typically, with that kind of configuration in the open interest, we would be nervous and would be looking at taking a profit. Indeed, we exited the market for a few days (leaving a gaping hole in our investors' portfolios that extended from $307 to $318 per ounce) but decided to get back on the long side when the market began to break into new high territory. While definitely a shoddy bit of trading, it seems – for the moment, anyway – that getting back in was the right decision.

Having said that, we should point out that the frenzied buying (including ours) we're witnessing is not baseless. The bullish fundamentals have been developing along with the rally.

Several weeks ago, when the US dollar began to decline in earnest, there was a school of thought among many mainstream currency analysts that the dollar was experiencing a due-course, counter-trend correction. But the dollar has now fallen close to 8% from this year's high, set in February, and is challenging 8-month lows. While not the only factor, gold traditionally has been the first commodity to be affected by a significant change in the US dollar, which certainly is happening in the current environment.

Although, the CRB commodity index has jumped 11% from its recessionary lows set last fall, many commodities that should benefit from a weakening US dollar through rejuvenated export markets (e.g., wheat and sugar) have languished. Gold's response has been far more immediate. Chart 5 shows gold outperforming the CRB index.

Then there is the matter of the hedge market. In its *Gold Survey 2000*, Gold Fields Mineral Services Ltd. documented the dramatic reduction in the global producer hedgebook (see *Focus on Futures*, April 25). The primary reason for the change in the attitude of mining companies towards the previously popular pursuit of selling production forward was the disappearance of the very attractive contangos.

A recent poll by Reuters shows that 16 out 21 economists believe that the Fed will embark on its first official act of tightening since it began its easing program. This is reflected in September Fed Fund futures, which are trading at an implied rate of 1.94% versus the current Fed Fund rate of 1.75%. Still, it will take a far greater move in rates to bring the contango anywhere near a level that will once again make it worthwhile for producers to hedge. This is particularly true when the gold market is in an uptrend. Dedicated shareholders may be quite unforgiving if they were to miss a bull market in gold.

To be sure, some producers will dabble in the hedge market. But we are reasonably comfortable that it will take a much higher price and much wider contango to bring hedging back to the levels we saw in the 1990s. In the interim, we are far more likely to see a further decline in the size of the global hedgebook, as producers scramble to lift hedges to take advantage of rising prices.

There is more reason than ever for investors to be looking for something fresh that is likely to retain value for their hard-earned investment portfolios. The stock market is weak across the board. Blue chips, large caps, mid caps, small caps, technology are all faltering.

For a while, small caps were outperforming the broader market, as investors, tired of mature industries and fallen angels, looked to areas not tainted by scandal and over-valuations. But that area has begun to fall apart as well. The Russell 2000, which was making new highs as recently as mid-April, has shed a nasty 7.5% over the past few weeks.

Yes, the gold market has that (short-term) overbought smell. But the reasons to own gold, as illustrated, are compelling. Fasten your seat belts for some bumps and grinds, but stay for the ride. *[May 30, 2002]*

STRATEGY: *Remain long August gold as per Flash Update of May 22. Maintain stops at 306, good anytime.*

Chart 3 – Spot gold

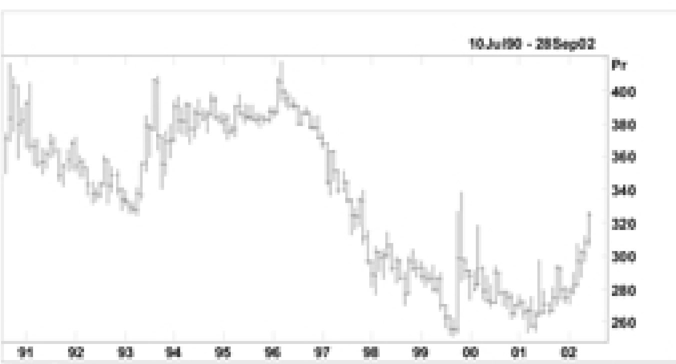


Chart 5 – Gold/CRB ratio

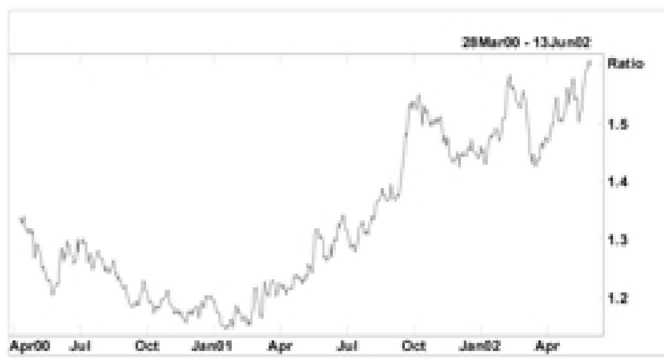
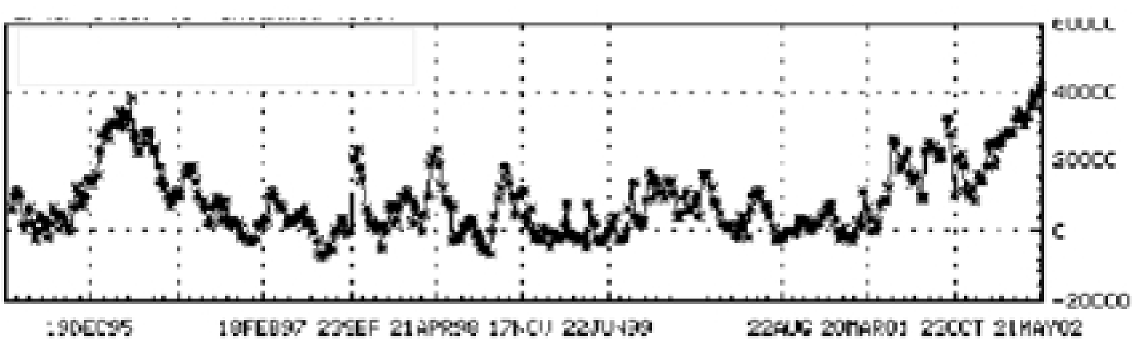


Chart 4 – Small speculators net long position



Courtesy Bloomberg

COPPER

Stronger economies should be creating demand, but are they?

The recent uptick in copper prices has had support from the headline news on both the demand and supply fronts. There is some evidence that producers are honoring the cutbacks they announced late last year. Chile, the world's largest copper producer, saw output in April fall by 20,000 tonnes, or 5.2%, over last April. If we were to annualize that output drop for Chilean producers, it would more than account for their fair share of commitments to the cutback program.

Earlier this week, BHP-Billiton surprised the market by announcing that it was going to slash output by an additional 80,000 tonnes at its Escondida mine. This is on top of the 170,000 tonnes it said it would cut back in November.

On the demand side, we are watching a constant stream of pertinent, strong economic data scroll buy. US industrial production grew 0.4% in April, the fourth consecutive month of improved output. Similarly, the most recent figures available from Europe show that industrial production in the EU grew 0.5% in March, the largest monthly increase since Europe began to emerge from its economic slowdown.

US auto sales for April were up 2.7%. Just this morning the Commerce Department reported that US factory orders for April grew by 1.4%, the largest monthly increase since October 2001, providing further evidence that the economy is strong in areas that will create demand for industrial commodities. The data have been constructive enough to establish a consensus among many economists that both the Fed and the ECB are on the threshold of a period of tightening monetary policy.

Having presented a mostly bullish case thus far, why are we short? Well, for starters, aside from the new production cut announcement, there is not much new in these macroeconomic developments. Strong data have been the trend we've seen for several months now. The market rallied sharply on the BHP-Billiton news – period – popping copper prices out of a two-month-old trading range. It seemed that the market was going to challenge the early April highs of 78¢ per pound, but the market has made no progress since the initial jump.

Still, copper prices have rallied dramatically off last fall's 60¢ per pound lows without much change in the copper balance sheet. Sentiment could easily drive prices through the 78¢-per-pound high, which prompted us to acknowledge the tape and alter our trading strategy with a much tighter stop.

The hard evidence, however, seems to indicate that the headlines are not doing very much for the bottom line where it matters most, in the production/consumption balance. After finishing 2001 with a bulging global surplus of 687,000 tonnes of copper, many copper analysts have been talking about a market that will move back into balance by the end of 2002. In a word, we're off to a bad start in achieving that goal.

The International Copper Study Group – one of the analysts that predicted that the market would be in balance by the end of the year – reported earlier this month that the surplus for the first 2 months of this year was 198,000 tonnes compared with a surplus of 15,000 tonnes in the same period last year. Production grew by 3%, while usage dropped 4.4%. The drop in Chilean production is being mitigated by increases in other significant regions such as Asia, Europe, and Oceania. Chinese consumption was strong, rising 18% for the period. But consumption declined in the US, Europe, and Japan.

Total warehouse stocks at LME, COMEX, and Shanghai combined have not budged much and still sit at 1.52 million tonnes compared with 1.54 million tonnes at the time we entered the short side.

One fundamental in the bear camp that has not changed is the average global cost of production, which is about 55¢ per pound. Many mines produce copper at well below the average cost of production, and there is little incentive for them to cut back.

Admittedly, we're not looking very smart right now with regard to this position and are on the verge of being taken out. Nevertheless, while the economic statistics (and the price action) do not support our case, the copper statistics do not support the bulls' case. *[May 31, 2002]*

STRATEGY: *Remain short July copper. Lower stops to 76.50, close only.*

Chart 6 – July copper

Courtesy Reuters

HOTLINE UPDATE

Friday, May 3, 2002:
Good afternoon for Friday, May 3, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long June gold, with our stop at 260; short June mini S&P, with our stop at 1135; and long July cocoa, with our stop at 1380. All stops are close only.

Flash Update **– Monday, May 6, 2002:**
Good morning for Monday, May 6, 9:15 am. This is a Flash Update. We have purchased July wheat at 268.5, placing our initial stop at 262, close only.

Friday, May 10, 2002:
Good afternoon for Friday, May 10, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are long June gold, with our stop at 260; short June mini S&P, with our stop at 1135; long July cocoa, with our stop at 1380; and long July wheat, with our initial stop at 262. All stops are close only.

Flash Update **– Wednesday, May 15, 2002:**
Good morning for Wednesday, May 15, 9:00 am. This is a Flash Update. We have liquidated our long June gold position at 307.60. We have also sold short July copper at 74.15, placing our initial stop at 78.10, close only.

Friday, May 17, 2002:
Good afternoon for Friday, May 17, 4:55 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short June mini S&P, with our stop at 1135; long July cocoa, with our stop at 1380; long July wheat, with our stop revised to 268.5; and short July copper, with our initial stop at 78.10. All stops are close only.

Flash Update **– Wednesday, May 22, 2002:**
Good morning for Wednesday, May 22, 9:10 am. This is a Flash Update. We have purchased August gold at 318.40, placing our initial stop at 283, good anytime.

Flash Update **– Wednesday, May 22, 2002:**
Good afternoon for Wednesday, May 22, 2:30 pm. This is a Flash Update. We have liquidated our long July wheat position at 269. We repeat our Flash Update of this morning, where we purchased August gold at 318.40, placing our initial stop at 283, good anytime.

Friday, May 24, 2002:
Good afternoon for Friday, May 24, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short June mini S&P, with our stop at 1135; long July cocoa, with our stop at 1380; short July copper, with our stop at 78.10; and long August gold with our stop revised to 306 good anytime. All other stops are close only.

Flash Update **– Thursday, May 30, 2002:**
Good morning for Thursday, May 30, 9:15 am. This is a Flash Update. We have purchased December corn at 228, placing our initial stop at 2.15.

Friday, May 31. 2002:
Good afternoon for Friday May 31, 4:50 pm. The following is a recap of our current open position recommendations, and our latest stop levels. We are short June mini S&P, with our stop at 1135; long July cocoa, with our stop at 1380; short July copper, with our stop revised to 76.50; long December corn, with our initial stop at 215; and long August gold, with our stop at 306 good anytime. All other stops are close only.

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