

# FRIEDBERG'S

## FOCUS ON FUTURES

Friedberg Commodity Management Inc.



Volume 6, No. 5 May 26, 2003

## A sinking dollar finally breathes some life into US wheat prices

After retesting the \$2.80-per-bushel low set in March, wheat prices experienced a rather chunky 40¢-per-bushel rally last week. Comments in the daily media reports focused on inclement weather in the various US wheat growing regions. Excessive rain in soft red winter wheat areas and dryness in the hard red winter wheat belt were threatening both yield and quality.

There are other forces at work, however, that could put bears on the defensive in the foreseeable future, even if US weather were to improve. On Thursday, Egypt announced the purchase of 120,000 tonnes of a mixed variety of US wheat, which raised hopes that the combination of low US prices and a plunging dollar had finally priced US wheat back into the market. At least part of the sale was achieved because US prices were actually slightly lower than French wheat of comparable quality, something we haven't seen in a very long time.

Early season forecasts for 2003-04 global production call for a rebound in the crops of the principal exporting nations, which were devastated by drought in 2002-03.

Canadian farmers harvested only 15.7 million tonnes of wheat in 2002-03, 25% less than 2001-02 output of 20.56 million tonnes, and substantially less when compared with the 5-year average of 24.5 million tonnes. Exports dropped in half in 2002-03, from 16 million tonnes, or 15.5% of world trade, to 8 million tonnes and only 7.8% of world trade.

According to Statistics Canada's March 31 planting intentions report, 26.4 million acres will be planted to wheat for the 2003-04 season, slightly above the previous year. On April 17, StatsCan estimated that this area will yield a crop of 25 million tonnes.

Canada's problems paled in comparison with Australia's. Drought conditions reduced the 2002-03 Australian crop to a scant 9.4 million tonnes, compared with 24 million tonnes in 2001-02, and a 5-year average of 22.6 million tonnes. Exports fell to 7 million tonnes, or 6.8% of world trade, from 16.4 million tonnes in 2001-02, or 15.2% of world trade. But subsoil moisture has been building up, and early forecasts by ABARE for the 2003-04 crop indicate that the crop could reach 24.3 million tonnes.

Over the past two seasons, Ukrainian output doubled

from a 2000-01 crop of 10 million tonnes, to crops of over 20 million tonnes. The country has transformed from a self-sufficient producer to a significant exporter of 7.5 million tonnes, which comprised 7.3% of world trade. Ukraine's production boom couldn't have been more timely, because it was able to step in and – to some degree – fill the export void left by the disastrous crops in Canada and Australia. But a very harsh winter has returned output back to 2000-01 levels. The agriculture ministry estimated last week that the crop would yield approximately 10-12 million tonnes, only half the output of the two previous seasons. This eliminates Ukraine from the world trade arena.

The recovery in the crops of the traditional exporters, though, overwhelms the one significant problem area that we've been able to identify, so in itself, the half-sized crop in the Ukraine doesn't change the landscape all that much. For that matter – as has been well documented on these pages over the past year or so – the supply side of the global balance sheet has been shrinking for years with no lasting bullish impact on US prices. Without a shift in export demand that would send business back to the US, it would be futile to look for higher prices. With only several weeks left to the

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marketing year, export commitments stand at 21.5 million tonnes, close to 3 million tonnes below last year's sales at this point of the season. Barring a miracle, the USDA forecast for sales of 23.8 million tonnes will not be achieved.

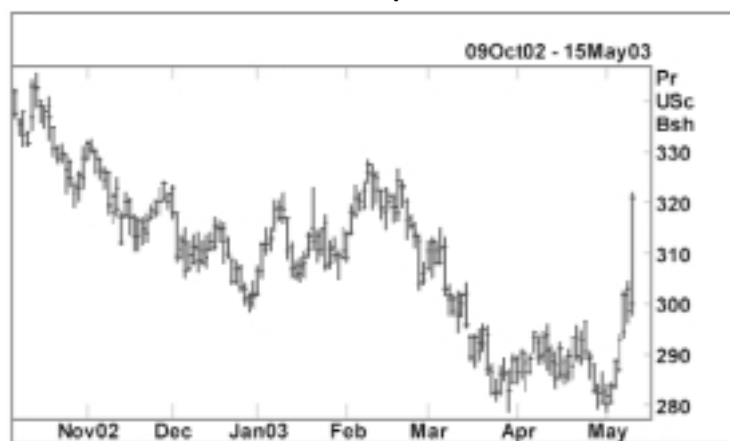
These statistics represent the past. The future looks more promising, though. While the collapsing dollar has played a visible role in some commodities, it does not yet seem to have affected demand for wheat. Perhaps last week's explosive rally signified a turnaround.

An important bullish factor that will manifest itself in the near term is the buildup of a hefty net-short position by commodity funds, facilitated by the bearishness that has prevailed

in this market. Even after reducing that position by over 6,000 contracts, CFTC data published on Friday show the group still net-short 13,000 contracts. These data were current as of last Tuesday and are probably stale, particularly in light of the late-week rally. Undoubtedly, there was a good deal of short-covering. So at least part of the job was done. But the bullish sentiment indicators that we look at are running at 52-week lows, and that is unlikely to be eradicated with one 5-day rally. We remain bullish, but having missed the initial thrust, we will wait patiently. *[May 12, 2003]*

**STRATEGY:** *Stay closely tuned.*

Chart 1 – July wheat



Courtesy Reuters

## **COTTON**

# **SARS and the liquidation of a massive long position create opportunities for cotton bulls**

Although there is no way to gauge precisely the impact SARS has had on cotton consumption in Asia, some market participants have taken the view that of all commodities, the dreaded disease will affect cotton demand most directly. July cotton nosedived by about 10¢ per pound, or 15%, over a 2-week period starting in late April. A series of bullish government reports have since caused a handsome 5¢-per-pound bounce (Chart 2). Where does this market head from here?

The bearish argument is quite logical. Consumer purchases in vulnerable regions should drop while large groups of people are either quarantined or just stay away from shopping malls voluntarily. Perhaps more troublesome for consumption is reduced manufacturing and milling activity that could result from a labor shortage while workers are quarantined, which in turn will reduce demand for raw cotton and bring to a halt the torrid pace of US exports.

The economic fallout related to SARS could be significant. Well-regarded Morgan Stanley economist Stephen

Roach recently lowered his growth forecast for Chinese GDP to an annual 6.5% rate from 7%. Industries involving tourism and public entertainment have suffered the most visible and devastating effects. It is not clear, however, how the disease will manifest itself in more micro areas, such as demand for individual commodities.

What we do know is that demand – when viewed in terms of the US export market – is humming along steadily. Two months ago – about the same time SARS surfaced in the headlines – export commitments were running about 1 million bales behind last year's pace. Commitments are now running neck-and-neck with last year's sales. Although China has not been a big buyer in recent weeks, it still has been buying. More importantly, we have not seen any significant cancellations, even from Asian countries.

Combined commitments among the biggest Asian Tiger purchasers of US cotton (China, Taiwan, Hong Kong, South Korea, and Thailand) stand at 3.44 million bales, 2.64 million

bales of which were already shipped. With 2½ months left to the marketing year, the balance to be shipped – 23% of commitments – is not a formidable amount, particularly when compared with the global unshipped balance of 3.28 million bales, or 30% of commitments.

On May 12, the USDA released its first look at the upcoming 2003-04 season. The world's largest exporter, the US, is expected to grow 17.2 million bales, the same as last season. Exports are expected to grow by 500,000 bales, to 11.5 million bales. With carryover stocks forecast at 4.7 million bales, or 25% of consumption, supplies will be the tightest since the 1999-00 season. Average ending stocks for the 3 seasons in between ran at 37% of consumption.

At the global level, production is forecast to increase substantially, by 8.6 million bales, to 96.5 million bales, or close to 10%. Although consumption is expected to grow by just over 1 million bales, to 99 million bales, the resulting 2.5-million-bales deficit will draw global inventories down further from this past season's 36.7 million bales, or 37.5% of consumption, to 34.5 million bales, or 34.8% of consumption, the lowest carryout since the 1994-95 season, when ending stocks were 28.3 million bales, or 33.4% of consumption. The bear market that took cotton prices down to below 30¢ per pound in 2001 was marked by ending stocks that hovered around 50% of consumption.

These USDA estimates are based on very early-season data and in all likelihood have not taken into account the potential of lower demand associated with SARS.

There is also another reason for the sharp drop in the market. Open interest rose dramatically with the rally off the 30¢-per-pound basement, doubling to almost 100,000 contracts. The rally saw commodity funds cover a large short position and then establish a record-size long position. As of this past reporting period, Commitment of Traders data show that the commodity funds are flat, indicating that the selloff we witnessed over the past few weeks was fueled by liquidation of this long position.

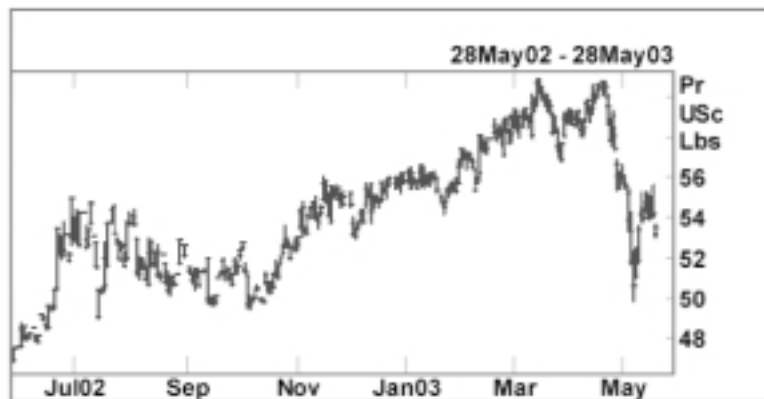
Although commodity funds are generally guided by technical analysis, there may have been an element of response to a perceived change in the fundamentals. In any case, it doesn't necessarily mean they were right to liquidate, but it does explain the size and magnitude of the drop in price.

While the effects of SARS on cotton demand remain ambiguous, we can say with certainty that the funds pushed this market down as they rushed to liquidate their burdensome long position. Now that this is no longer the factor it was several weeks ago, we can have greater confidence that market action will reflect more accurately supply/demand issues.

In conclusion, we are drawn to the bullish camp by shrinking world ending stocks, and we are watching carefully for an opportunity to enter the long side. *[May 21, 2003]*

**CURRENT STRATEGY:** *Long July cotton as per Flash Update of May 23. Place initial stops at 49.75, close only.*

Chart 2 – July cotton



Courtesy Reuters

## COPPER

### An impressive rally in the face of a flood of new production

Copper prices have been firming over the past month against a background of developments that could have been bearish for prices.

The anticipated increase in mine production in Chile – the world's largest copper producer – is now in full swing. The

expansion at Escondida – the world's largest mine – was completed at the end of April and it is now running at full capacity.

Chilean output for 2002 fell for the first time in many years, but only because of a concerted effort by copper producers to reduce production to put a floor under tumbling

world prices. With the aid of demand generated by a mild recovery in Western economies and a strong Chinese economy, the plan worked. However, a bullish supply side would be only a temporary factor because, even while the production cutbacks were being implemented, the planned expansions were being developed at full throttle. The miners were not building these mines only to idle them upon completion. In fact, production has been up every month this year, with year-over-year gains of 3.9% in January, 9.6% in February, and 8.8% in March.

There has been a lot of discussion about what effect the outbreak of SARS would have on commodity consumption. It seemed that this would be of particular interest in Asia generally and in China specifically where strong consumption has been the most bullish element of the global copper market over the past two years and where the disease has taken its greatest toll. Such fears were probably responsible for the sharp drop in price during March. Apparently, though, the current rally is an indication that the market has failed thus far to establish a connection between the disease and copper consumption.

Despite worries about SARS and the unclear outlook for the US, European, Chinese, and Japanese economies, the hard data seem to show that demand is quite steady and is absorbing the sudden jump in Chilean production this year. The most recent report from the International Copper Study Group shows that the production/consumption surpluses of 2001 and 2002, which had allowed burdensome inventories to accumulate, are in fact shrinking. For the first 2 months of 2003, the global surplus stood at 52,000 tonnes, compared with a sur-

plus of 161,000 tonnes for the same period in 2002. Mine production increased 53,000 tonnes in the period. But output of refined copper actually fell 28,000 tonnes, while usage grew by 82,000 tonnes, which explains why the market has tightened even though Chile has ramped up mine output.

The tightness has also been reflected in warehouse activity. LME stocks stand at 767,000 tonnes, down from 980,000 tonnes one year ago. NYMEX stocks have fallen to 339,000 tonnes from 399,000 tonnes in January. Shanghai stocks have bounced to 60,000 tonnes over the past 2 weeks, but are sharply below the 248,000 tonnes they reached in April 2002.

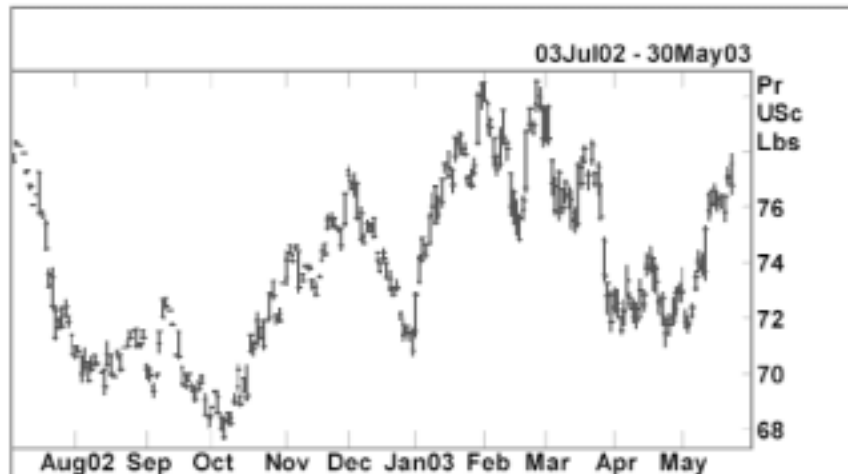
Commodity funds built up a large short position but were unable to break the back of the market, with the market showing solid support at the 71¢-per-pound level. The move up to 76¢ per pound was certainly associated with fund short-covering. Last Friday's CFTC report showed the funds moving to a net-short position of 2,900 contracts from 15,000 contracts the previous week. So, to some degree, the strength in price was not necessarily directly related to a sudden, bullish shift in supply/demand fundamentals.

Still, the fundamentals – as illustrated – are constructive for the bull camp. Considering the growth rate of fresh mine supply, however, usage would have to be equally strong to absorb it all. To be a comfortable long, one would also have to have a positive outlook for the economic fortunes of the important copper-consuming regions around the globe. That picture is still cloudy so we remain sidelined, but interested.

[May 22, 2003]

**STRATEGY:** *Stay closely tuned.*

Chart 3 – July copper



Courtesy Reuters

**SUGAR**

## A mixed outlook for the sugar market

Although the fundamentals for the sugar market have been generally bearish over the past year or so, recent action in the sugar market may have had little to do with supply/demand balances of the physical commodity. The rally to 9¢ per pound from 5¢ (Chart 4) saw a historic buildup in open interest which rose to over 275,000 contracts from 130,000 contracts (Chart 5).

In previous articles about sugar, we argued that commodity funds were overcome with a bullish sugar bug that drove them to build a net-long position of, at one point, almost 75,000 contracts. The fundamentals did not support a 9¢-per-pound sugar price, and the ensuing liquidation drove prices down by close to 2½¢ per pound.

The net-long position has now been reduced to 5,000 contracts. Even with surpluses and huge carryover stocks, the slide was exacerbated by the liquidation. With the fund factor out of the way, prices should begin to reflect *bona fide* fundamentals. What are they?

As 2003-04 Southern Hemisphere crops are being harvested, the books are closing on the 2002-03 season. Arguably, the most important bit of information to emerge recently was Czarnikow's revisions to its estimates for the 2002-03 season.

Early in the season, most analysts were talking about a global sugar surplus of about 5 million tonnes. As the season wore on, that surplus was reduced steadily and over the past few months was believed to be about 2 million tonnes.

It was therefore quite newsworthy when on May 20, press reports carried Czarnikow's new estimate for a 5.27-million-tonne surplus, which was considerably higher than its own most recent February estimate of 2.636 million tonnes. At least part of the increase to the surplus was the result of an overestimation of consumption.

The price outlook for the 2003-04 season is somewhat more positive. We have a fairly good idea of what Southern Hemisphere crops will look like, but Northern Hemisphere crops won't be harvested for many months and are still subject to the whims of the weatherman.

Despite the fact that Brazil is about to harvest its third consecutive bumper crop and retain its status as the world's largest producer and exporter of sugar, all is not bearish on

that front. The cane crop is expected to come in about 5% higher than last season, but little if any of the increase will be processed as sugar. Rather, the production of ethanol will continue to rise as the government builds stocks of the cost-effective and environmentally-friendly gasoline substitute. Analysts estimate that ethanol output in Brazil will jump by 13.5% during the 2003-04 marketing year, to 12.6 billion liters. Specifically, this will manifest in a decline in exportable sugar of about 2 million tonnes, to 9.5 million tonnes.

Another potentially bullish factor is Australian production. Australia struggled with drought all of last year, and the effect was devastating for many commodities it grows. Actually, sugar fared better than most other crops last year, but dry conditions in the sugar regions are expected to reduce the new crop by 10% to 15%, or about 500,000 tonnes.

Australia is a major exporter to the Asian market, but production in the other major producing countries is expected to be strong. China produced a record 10 million tonnes in 2002-03 and should repeat that performance in 2003-04. But with consumption estimated to jump by about 1 million tonnes, to 10 million tonnes, China may have to import to fulfill its domestic needs.

Thailand, the other major Asian grower/exporter, is expected to harvest a record crop of close to 7 million tonnes, up from 6.5 million tonnes in 2002-03, which should compensate in part for the Australian shortfall.

Early forecasts for the 2003-04 global production/consumption balance range from a small deficit to a balanced market. The carryover from 2002-03 leaves the market well supplied, but as illustrated, the market may tighten from here on in.

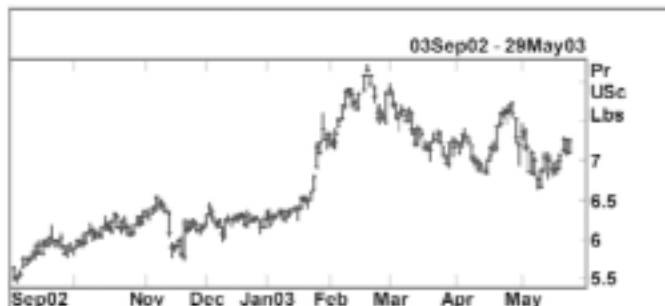
A key issue will be the price of gasoline. If petroleum prices remain strong, there will be greater incentive for Brazil to convert more cane into ethanol, leaving less sugar available for the export market.

In conclusion, despite the bullish tone to the 2003-04 season, we maintain a bearish bias. Czarnikow's surprise increase for the 2002-03 surplus indicates that consumption is weaker than earlier believed. We remain sidelined but interested in the short side.

[May 23, 2003]

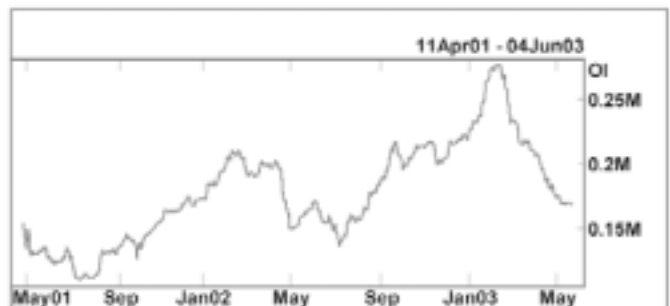
**STRATEGY:** *Stay tuned.*

Chart 4 – July sugar



Courtesy Reuters

Chart 5 – Sugar open interest



Courtesy Reuters

## HOTLINE UPDATE

### **Flash Update – Tuesday, May 6, 2003:**

Good morning for Tuesday, May 6, 9:35 am. This is a Flash Update. We have sold short June mini S&P at 925.75, placing our initial stop at 940, close only.

### **Friday, May 9, 2003:**

Good afternoon for Friday, May 9, 4:40 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On May 6 we sold short June mini S&P at 925.75; we are currently long June gold at 336.20, with our stop revised to 330; long November soybeans at 530.50, with our stop revised to 525; long July coffee at 64.45, with our stop at 63.00; long June Canadian dollars at 0.6726, with our stop revised to 0.7067; long June euro currency at 1.0628, with our stop revised to 1.1264; and short June mini S&P at 925.75, with our initial stop at 940. All stops are close only.

### **Flash Update – Monday, May 12, 2003:**

Good afternoon for Monday, May 12, 5:15 pm. This is a Flash Update. We have covered our short June mini S&P at 944.75.

### **Flash Update – Thursday, May 15, 2003:**

Good afternoon for Thursday, May 15, 3:10 pm. This is a Flash Update. We have liquidated our long June euro position at 1.1385.

### **Friday, May 16, 2003:**

Good afternoon for Friday, May 16, 4:50 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendations and stop levels: On May 12 we covered our short June mini S&P at 944.75; on Thursday, May 15 we liquidated our long June euro at 1.1385; we are currently long June gold at 336.20, with our stop at 330; long November soybeans at 530.50, with our stop at 525; long July coffee at 64.45, with our stop at 63.00; and long June Canadian dollars at 0.6726, with our stop revised to 0.7168. All stops are close only.

### **Flash Update – Friday, May 23, 2003:**

Good afternoon for Friday May 23, 1:30 pm. This is a flash update. We have purchased July cotton at 53.27, placing our initial stop at 49.75, close only. We have liquidated June Canadian dollars at 0.7247.

### **Friday, May 23, 2003:**

Good afternoon for Friday May 23, 3:00 pm. The following is a recap of this last week's trade recommendation history, and our latest recommendation and stop levels: On Friday May 23 we recommended the purchase of July cotton at 53.27 and the liquidation of June Canadian dollars at 0.7247; we are currently long June gold at 336.20, with our stop at 340.00; long November soybeans at 530.50, with our stop at 5.39; long July coffee at 64.45, with our stop at 63.00; and long July cotton at 53.27, with our stop at 49.75. All stops are close only.

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