FRIEDBERG'S
FOCUS ON FUTURES
Friedberg Mercantile Group Ltd. Volume 9, No. 4 May 1, 2006

Cocoa: Disappointing Ivorian output and growing demand

Virtually all supply/demand fundamentals reported for the cocoa market recently have been bullish. Despite this, prices managed to trade down to 5-month lows and came within striking distance of breaking the long-held $1,300-per-tonne support level.

The main-crop in the Ivory Coast ended officially on March 31 at 915,000 tonnes, below last year's 945,000 tonnes, and well below early season forecasts. Hope for salvaging what was supposed to be a recovery year has been pinned on the mid-crop, which is widely expected to be above average and to reach 300,000 tonnes by some analysts' estimates. Early results are somewhat disappointing. Mid-crop arrivals are just a tad ahead of last year's pace, and quality is reportedly on the poor side.

Crops of the other West African producers don't receive as much attention but collectively comprise close to 30% of global production. In terms of E.D.& F. Man's February estimates, only the Ghanaian crop will meet expectations of 630,000 tonnes. Arrival data for Cameroon and Nigeria have fallen below last year's levels, and – from the sketchy data available to us – it seems that output from these two countries could be as much as 50,000 tonnes below early season estimates.

Brazilian production, on the other hand, seems to be running ahead of Man's estimate by over 30,000 tonnes. The main harvest in Indonesia is just getting under way.

Given the progress of the world's principal cocoa crops, Man's estimate for total global output of 3.2 million tonnes for 2005-06 is a bit on the high side, but certainly in the ballpark. But there is no room for any glitches. An Ivorian main-crop of just over 900,000 tonnes and a mid-crop of 300,000 tonnes should make Man's 1.195-million-tonne forecast.

As it is, Man's estimate for global grindings of 3.4 million tonnes will leave a deficit of 200,000 tonnes. A disappointing main crop would alter the landscape.

The demand picture threatens to tighten global inventories as well. First-quarter grindings in Europe were up 9.2% over last year, mainly because of a 35.4% jump in German grindings. Even the US, which has had sluggish grinding activity in recent quarters, was up 2.9%.

The generally positive grind results are especially encouraging because butter ratios have been eroding slowly and steadily from last year's peak of well over 3 times the London spot month to about 2.5 times. One would think that with grinding margins softer, there would be less incentive to grind. It does not seem to be the case, however, and in a market that is not generously supplied with information, the hard data of reported grindings would seem to be a good indication that demand is growing at a healthy clip.

We estimate that with slightly lower than expected output and slightly higher than anticipated consumption, the stocks-to-consumption ratio is probably below 40%, which even for cocoa is not alarming, but certainly puts the market in a vulnerable position.

Inside

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The most recent Commitment of Traders data show that commodity funds are now net-short over 5,000 contracts. Although this can hardly be considered an extremely oversold condition, it is clear from the behavior of the open interest that commodity funds tried to break the back of the market. The sharp rally we had over the past few days, however, also makes it clear that they were unsuccessful.

In the short term we can expect a short-covering rally, which in all likelihood is already well under way. Down the road, we see potential for significantly higher prices. As illustrated, there is no room for anything but a perfect mid-crop in the Ivory Coast. In addition, it seems that consumption was underestimated, which will result in a larger deficit than the street currently believes is possible. Remain long. *[April 25, 2006]*

Chart 1 – July cocoa

Courtesy Reuters

SUGAR

Major producers respond to high prices with huge crops

In the March 28 issue of *Focus on Futures* we declared an end to the initial phase of the "sugar shock." Prices moved higher for several days after the article was published, but have edged lower since (Chart 2). The chart remains in an uptrend and appears to be in fine shape, but we maintain the view that the fundamentals are not quite as bullish as they've been. For the immediate future, we expect prices to drift.

The situation in India is really very typical of what we should expect in the aftermath of such a powerful bull run. Even estimates for the current (2005-06) crop keep inching up and now stand at 19 million tonnes. This is well above early season forecasts, and is probably an indication that the high prices have allowed farmers to spend more on crop inputs.

Analysts expect 2006-07 Indian output to reach 22 million tonnes, above the 2002-03 record crop of 21 million tonnes. Naturally, the results are largely dependent on the June through September monsoon season, which at the moment is expected to produce somewhat below-average precipitation. The 2002-03 bumper crop coincided with the wettest monsoon season in a decade, whereas the following two disastrous crops were the result of drought. The harvest of the new crop does not begin until October, but the weather will give traders a very good idea of how the crop will turn out.

Until recently, strict regulations reflected a specific goal of keeping domestic prices in check by restricting exports. With crop size improving, the government in India is apparently feeling comfortable enough to continue reforming the export market. As we noted last month, the relaxed policies will obviously bring an end to the era of huge carryover stocks. With a 22-million-tonne crop just around the corner, the Indians can afford the complacency. But regardless of whatever short-term opinion we have of this market, this could become a very bullish factor somewhere down the road. Per-capita domestic consumption in India is roughly twice that of China. Living hand to mouth will backfire if the Indians ever have a crop failure again. For the moment, though, India's new status as an exporting country is clearly a bearish factor.

The ratio of ethanol to sugar produced from Brazil's cane crop crept over 50% this past season, with ample predictions that we're headed towards a 55%/45% ratio. The recent downturn in ethanol usage in Brazil, small as it may be, has sugar analysts talking about the ethanol/sugar ratio slipping back to 50%/50%. We are not talking about a huge difference, but it does illustrate that ethanol demand has responded to rising prices. The urgency that characterized this market for fear of Brazil not being able to meet its sugar export commitments is gone, for the moment anyway.

One would have thought that with crude oil prices trading $5 per barrel above last summer's high, sugar prices should have responded with new highs of their own. Although ethanol prices in Brazil have fallen by some 15% over the past month, this does not seem to have reignited consumption. Prices are still close to double what they were about one year ago. Even with prices stabilizing, it seems that the substitution benefits of ethanol are no longer as great.

Sugar analyst J. Kingsman presents a sobering forecast for the sugar market, estimating a global surplus of just over 1 million tonnes for the new marketing year, compared with a deficit of 2 million tonnes in 2005-06.

It is not as if we are bearish on the sugar market and are about to recommend a short position – for that matter, we strongly caution even those who are bearish to proceed with extreme caution. But we have to remember that open interest has grown by ridiculous proportions, and commodity funds exacerbated the rise to some degree. Even after shedding 80,000 contracts, the open interest is 450,000 contracts, compared with a high of 200,000 contracts before the bull market began. The net-long position held by the funds has barely changed during this drop in open interest, and we believe that a traditional-style cleanout is a distinct risk. We stand aside. *[April 27, 2006]*

Chart 2 – July sugar

Courtesy Reuters

COPPER

Skyrocketing prices not supported by fundamentals

The vulnerability of the bull market in copper was exposed on April 27 when China announced that it was increasing its one-year lending rate by 0.27%. The rate hike comes on the heels of the April 19 release of GDP data, which showed that the Chinese economy grew at an annual rate of 10.2% in the first quarter.

The central bank's move was seen as an attempt to quell the torrid pace of investment, and ultimately inflation. The tightening – copper traders reasoned – would have a direct and immediate impact on demand for raw materials. COMEX copper for May delivery tumbled by 13.5¢ per pound, or 4%, on the news. In the grand scheme of things the reaction was not such a big deal, considering that prices are up 70% since the beginning of the year (Chart 3).

In April alone the market rose by as much as 35%, allegedly because of labor unrest in Mexico. Mexico is a significant producer. The strikes are entering their second month and involve thousands of mine workers.

To put the resulting supply disruptions in perspective, however, consider that 2005 copper mine production in Mexico for copper was 368,000 tonnes, dwarfed by 2005 Chilean output of 5.3 million tonnes. No doubt the strike is a significant event, but strikes do end eventually. We believe that the monstrous leg of the bull market we witnessed over the past several weeks was an overreaction in terms of the effect on the global supply/demand balance. A complete halt to the industry in Mexico for two complete months would mean the loss of about 60,000 tonnes of copper. Important, but not crippling.

The release of the most recent production statistics out of Chile coincided with the Chinese interest rate news and showed that output fell by 1.4% in March. While the Chilean data only contributed to the bullish supply case, it was drowned out by the potentially bearish demand development. The slip in output is particularly disappointing in light of the strong increase in February output of 6.1%. After many months of zero growth in production, it seemed that Chilean mines had finally responded to soaring prices.

Despite all the supply side issues, global statistics do not support the surge in prices. On March 16, The International Copper Study Group (ICSG) released its final global summary for 2005, and surprisingly, after running at a deficit all year long, the market was almost in balance, with a marginal 2,000-tonne surplus because of a huge, 185,000-tonne surplus in December.

In January ICSG recorded a surplus of 60,000 tonnes. Production in other regions has been filling in the gaps left by regions with supply disruptions. Mine production in January was 1.243 million tonnes, compared with 1.203 million tonnes in January 2005. Usage was 1.358 million tonnes, versus last January's 1.392 million tonnes.

ICSG data are three months behind, and as illustrated the recent hard supply data have been bullish.

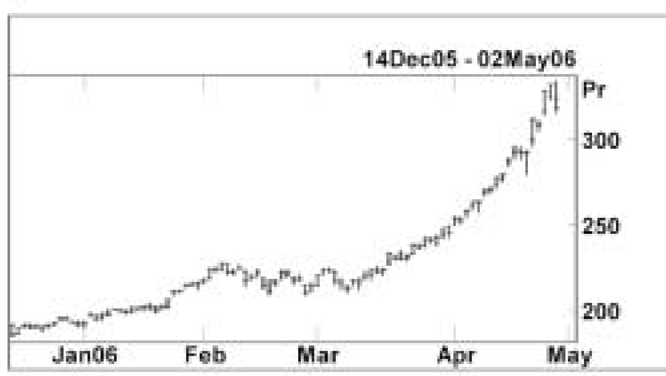
Warehouse stock data are also more representative of current events and have come off from their cumulative peak of about 200,000 tonnes a few months ago to 168,000 tonnes.

Still, there is absolutely nothing to suggest that the magnitude of this rally is warranted. Developing fundamentals have leaned to the bullish side, but the overall global supply/demand balance has moved from a massive deficit in 2004 to a balanced market in 2005.

The market is being driven by the commodity fund investment community, which has staying power, so we are not going to attempt an outright short position. Prices remain in backwardation, which is no great surprise for a market rife with *force majeures*. The July/September spread has widened on this recent rally (Chart 4), and we believe that selling the spread is a reasonable bear play. Use any close in the spread above the November highs as a stop.

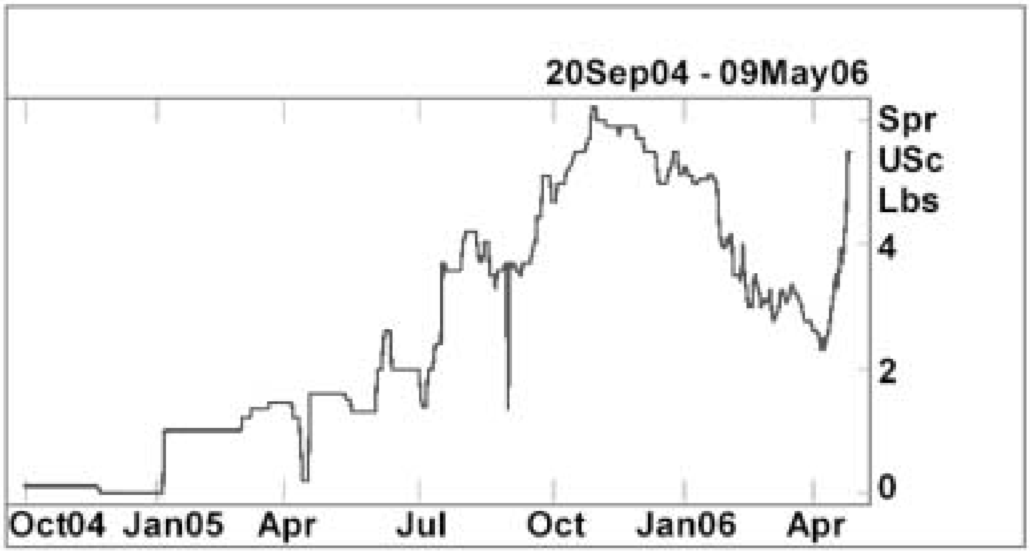
[April 28, 2006]

Chart 3 – July copper



Courtesy Reuters

Chart 4 – July/September spread



Courtesy Reuters

SOYOIL

Anticipation of growth of bio-diesel pushes soyoil/meal spread into uncharted waters

With crude oil prices making new all-time highs and consumers watching nervously as prices at the pump rise daily, alternative fuels have received a lot of attention. President Bush has addressed the issues surrounding dependence on foreign petroleum several times in recent weeks. ADM, the huge commodity firm, broke company tradition and hired an oil executive to be the new CEO. The move reflects the new reality that the grain business is now an energy business as well.

The financial media has focused primarily on ethanol because of the size of the corn and sugar markets and the fact the consumer markets are already developed, particularly in the case of Brazil. Bio-diesel has not sparked as much interest, but production and consumption are growing, and commodity traders have certainly not ignored the potential trading opportunities.

When we last discussed soybean oil specifically (*Focus on Futures*, November 4, 2005), we recommended a long oil/short meal spread as a vehicle for trading anticipated growth in demand for bio-diesel fuels. Our timing was not perfect, but the spread eventually traded up to seven-year highs in favor of the oil side.

Hard data for soy-based bio-diesel are scarce, so we'd like to present some general information about the market to provide signposts for things to look for as the market grows.

The general data for soyoil have not reflected any great surge in demand thus far. For the most part, the 10% to 15% jump in global soyoil consumption over the past 2 years, which had nothing to do with fuel, has been met by increased output. The market is fairly balanced. US stocks are large as we head toward the end of the marketing year.

The US Census Bureau just began publishing statistics in January, and those data show that soyoil converted into fuel represents only a fraction of total US consumption – about 2%. This compares with 15% for US corn-based ethanol in the 2005-06 marketing year and expectations for significant growth in the coming season.

The incentive to develop commercial viability is strong. Before the bull market in petroleum really took off, USDA data show that it cost $1 to $1.50 more to produce bio-diesel than petro-diesel. With crude oil at $70 per barrel, that gap is all but gone.

Turning to the supply side of soybeans, the US grew its second largest crop this past season, and the early outlook for 2006-07 is for another large crop. The USDA forecasts that planted acreage will increase by 2 million acres, or 3%, over 2005-06. US 2005-06 ending stocks can only be described as burdensome, with a carryout of 565 million bushels, or 20% of consumption. This compares with 4.5% in 2003-04 and 8.6% in 2004-05.

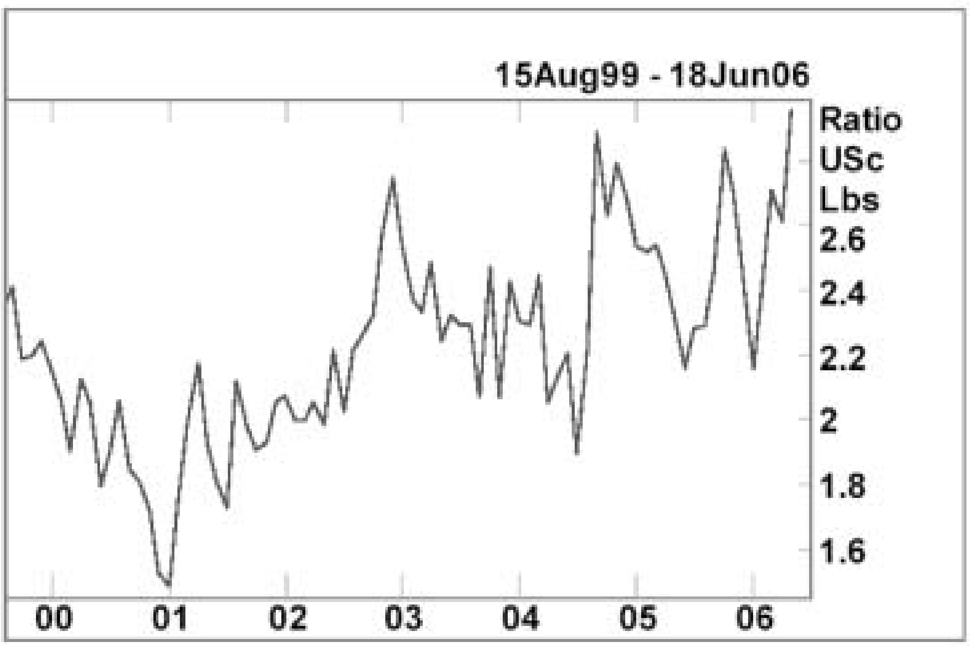
Brazil and Argentina grew their largest crops ever. This should keep soybean prices languishing near their current range.

Thus, even if/when the soy-based diesel market really catches on, there will be no initial supply shock, because there are plenty of soybeans around. Naturally, a bad crop will change the dynamics.

The issue for the soyoil market will be its relationship with soymeal. A bushel of soybeans produces on average 48 pounds of meal and 11 pounds of oil. There is very little wiggle room for the extraction ratio, but the growth of the biodiesel market will provide an incentive to increase the ratio in favor of oil. The only known option available for increasing oil content is genetic engineering.

We believe that the spread will continue to widen in favor of soybean oil, but we advise waiting for pullbacks to establish new positions. *[April 28, 2006]*

Chart 5 – Soybean oil/soybean meal



Courtesy Reuters

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