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Friedberg Mercantile Group Ltd.



Volume 12, No. 3 May 1, 2009

Sugar: India becomes a net importer

India's decision earlier this month to relax restrictive import regulations sparked a 1.5¢-per-pound rally in the sugar market (Chart 1). Duties would be temporarily scrapped and the requirement to re-export within a certain time frame would be dropped.

There were skeptics, but as we've been saying all along, it was an inevitable move for India. Production in 2008-09 fell to below 15 million tonnes, from over 25 million tonnes in 2007-08. With domestic consumption of 22 million tonnes, carryover stocks have been run down to negligible levels. This creates a very uncomfortable situation. Sugar demand is fairly inelastic in India. It is an inexpensive carbohydrate for the masses, and the government has always ensured availability and will continue to do so. Besides, as the economy modernizes, sales of confectionaries have increased alongside the growth of malls and Western-style eateries.

For now, Indian imports for 2008-09 are estimated at 3 million tonnes, which together with current stock levels is barely enough to satisfy demand that is forecast at 22 million tonnes. We expect further liberalization of import legislation, which would pave the way for more foreign purchases. The current mandate removes the 60% tariff on only 1 million tonnes for four months.

Looking ahead, forecasts for the 2009-10 crop, which begins its harvest in October, are in the 21-million-tonne area. With favorable weather there is no reason to assume that we won't see a return to a normal crop size. Still, we believe that it will not stop the government from facilitating imports, because it has a keen interest in rebuilding inventory levels.

In Brazil, the 2009-10 harvest season is in full swing and a record 38-million-tonne crop is expected. The sugar/ethanol ratio is currently running at about 43% sugar to 57% ethanol, up from last season's 40% sugar to 60% ethanol. Brazilians still have to use a minimum 25% ethanol to fill up their tanks. While global car sales have been dismal, Brazil has bucked the trend. The government took an aggressive stand late last year by introducing tax breaks for new car buyers, and sales have been excellent in every month since. In March, sales were up 36% over February and 17% above March 2008. The incentives last until June 30, but are expected to be extended until the end of 2009.

The overall Brazilian economy is not faring any better

than other countries hit by the worldwide recession. Recently released IMF figures forecast that GDP will fall 3.7% in 2009. Nevertheless, it would seem that the ethanol-sensitive automotive sector will be insulated to some degree by the government initiative.

All the principal European analysts have revised their forecasts for the 2008-09 global balance sheet to account for the drop in Indian output. The expected deficit has increased from the 5-million-tonne range earlier this year to close to 12 million tonnes. Early forecasts for 2009-10 are for a 2- to 3-million-tonne deficit. The notion of "burdensome" global carryover stocks that equal 50% of consumption or what have you are – as we've argued in the past – a misnomer. Most of it is in dribs and drabs and belongs to countries that are not a factor in world trade. In any case, many countries seek to maintain a reasonable level of stocks, and are not likely to become exporters. The pool of inventories that is available for export is relatively small.

Stepping back for a minute, while the reaction to the Indian import-regulation reforms was reasonable, it did not lift sugar prices out of their 2009 13¢- to 14¢-per-pound trading range. We attribute this to the fact that the news out of India was a foregone conclusion and was not a shock to the market, which probably limited the gains – in the short run. The introduction of India as a net importer is a powerful new dynamic, however, and the market is now in a very vulnera-

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ble position. The supply side must behave perfectly to avoid a major upside breakout.

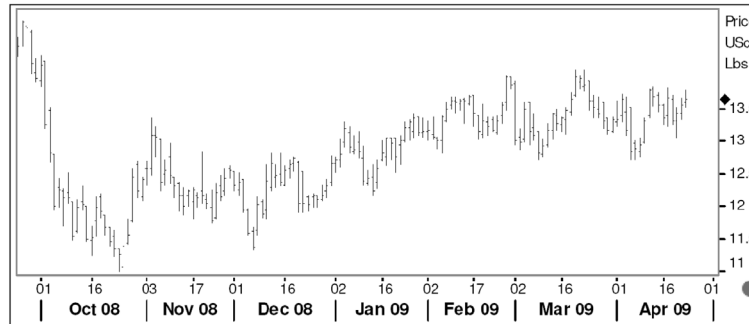
Charts 2 and 3 show that the speculative presence on the long side is formidable, but that the recent strength did not

bring in a new wave of longs. Open interest actually fell a bit, which could mean that there is ample speculative interest on the sidelines once the bullish fundamentals become apparent.

Remain long July sugar.

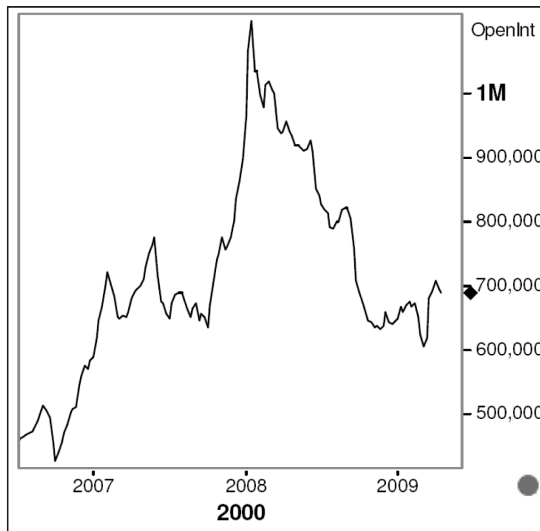
[April 24, 2009]

Chart 1 – July sugar



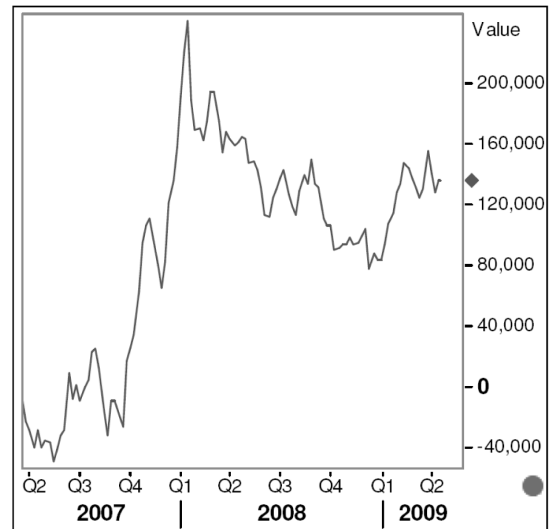
Courtesy Reuters

Chart 2 – Open interest



Courtesy Reuters

Chart 3 – Commodity fund net long position



Courtesy Reuters

COCOA

Demand is grinding to a halt

On April 6, just after touching multi-month highs, cocoa prices took a \$250-per-tonne drubbing (Chart 4). The drop came just ahead of the release of European and North American grind data for the first quarter and in anticipation of weak numbers.

The German grind, which makes up about 25% of European activity, was reported on April 9 and came in 21.3% below the first quarter of 2008, in line with expectations of a 20% decline. The balance of the slate was not much of a surprise, with Europe down 11.1% and North America 12.97% below last year. (Effective this past quarter the

National Confectioners Association will report the North American grind, which has been expanded to include Canada and Mexico instead of only the US. The data have been recalculated going back to the first quarter of 2008 for comparison purposes.)

Subsequent to the initial nasty one-day drop, prices continued to fall throughout the grind-reporting season. The market has consolidated over the past week.

Other demand-side indicators also confirm that the worldwide recession has taken a toll on consumption. Butter ratios in both the European and Asian markets have fallen to

below two times the London spot price, a level not seen in five years (Charts 5 and 6).

The bullish case was on the supply side. A sharp drop in output kept prices at levels that are still well above historic norms (Chart 7). However, those factors are not nearly as supportive as they were several months ago.

The main-crop harvest in the Ivory Coast is over, and arrivals stand at about 85% of 2007-08 levels. Regardless of how well the mid-crop performs, Ivorian output will contribute about 150,000 tonnes less to global supply than it did in 2007-08. Normally, that would represent enough of a deficit to keep the market worried. But the arrival pace has improved consistently since the start of the season in October, when at times it seemed that the Ivorian crop would be a total disaster. So considering the poor weather and other negative production issues that plague the Ivory Coast, main-crop results were as good as, or better than, anyone expected.

Like the Ivory Coast, neighboring Ghana will produce a larger-than-expected crop. Arrivals were also running well behind year-ago levels, but picked up as the season wore on. Output is now forecast at about 650,000 tonnes, above last year's total.

The outlook for Indonesian output is far improved. At one point – just a few months ago – it seemed as though disease would reduce production significantly. But the main crop has exceeded expectations, and the full-year crop is now estimated at about 500,000 tonnes, a tad above 2007-08.

The only supply variable at this moment is the Ivorian

mid-crop. We've seen estimates drop by about 50,000 tonnes recently, after early forecasts that put output as high as 330,000 tonnes.

The overriding issue in this market at present is demand. Most analysts have focused on the poor Ivorian showing all season long, and their deficit forecasts are likely to be revised. As recently as April 1, Fortis forecast that the global stocks-to-consumption ratio would fall from 40% in 2008-09 to 35% in 2009-10, which is low for the cocoa market. For that to happen, though, we would need to see an improvement in demand.

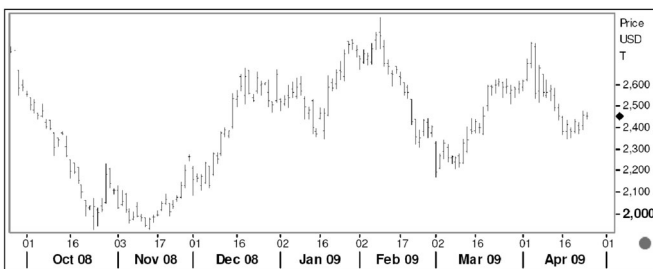
We believe that production in the Ivory Coast will continue to suffer from aging cocoa plantations. The underlying financial problems that have resulted in poor adherence to application of pesticides and other inputs have not been solved. On the other hand, falling consumption has delayed the urgency of producing a larger crop in the near term.

Cocoa is in a long-term bull market, but obviously, prices are not high enough to stimulate the necessary investment for the Ivorian production infrastructure, leaving the market vulnerable to a post-recession period when consumption turns around.

Long-term investors should maintain conservative long positions that can be held through sharp pullbacks. This one may not be over yet. Traders should place sell stops at \$2,350 per tonne, basis July, close only. If this consolidation fails, we could easily see the market slip \$300 to \$400 per tonne.

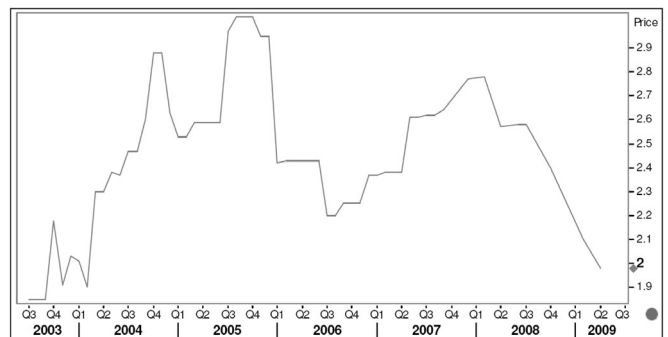
[April 27, 2009]

Chart 4 – July cocoa



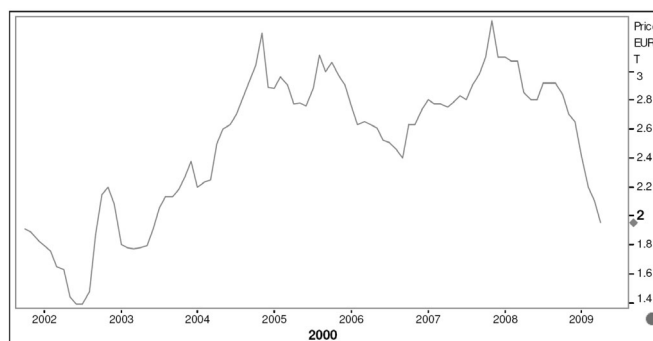
Courtesy Reuters

Chart 5 – Asian butter ratios



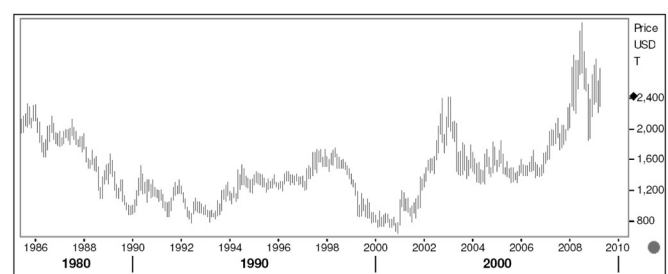
Courtesy Reuters

Chart 6 – European butter ratios



Courtesy Reuters

Chart 7 – Cocoa, nearest contract monthly



Courtesy Reuters

COTTON

The bear is gone

Census Bureau data released on April 23 showed that US cotton-mill usage in March was 291,485 bales. While still down sharply from last March, when 402,157 bales were milled, it was the largest tally since October's 333,718 bales and well above the average of the past few months.

A positive indication for US domestic consumption is an interesting development, but has been downplayed by analysts. The general tone on the street is that we've yet to see the worst for demand for goods and services. It will take more than one month of improved consumption to convince anyone that the market has turned the corner.

When looking at the broader issues in the US cotton market, however, the uptick in mill-usage could mean that we are in a transition phase that will lead to a new bull market. In fact, the weak link in the cotton market has been US consumption. The potential for an improvement in that sector may very well round out the other areas of the market, which have been bullish for some time.

Overseas demand is stronger than earlier expectations. As recently as February, the USDA estimate for 2008-09 US exports was a season-low 11.5 million bales. In both March and April that estimate was raised by 500,000 bales because of a steady flow of weekly commitment numbers. At 12.5 million bales, annual US exports are still shy of 2007-08 final sales of 13.65 million bales, but much larger than anyone would have believed was possible a couple of months ago.

And there is potential for further improvement. There have been reports that China will embark on a restocking program to keep the domestic mill market well supplied, much the same as it did with soybeans over the past few months. Chinese commitments to date are 3.6 million bales, up from 3.3 million bales at this time last year. On April 22,

a USDA attaché report estimated that Chinese cotton imports in 2009-10 would increase by 85% over 2008-09, to 13 million bales. The report cites smaller acreage and anticipation of an economic recovery that would increase demand.

Total US export commitments are already up to 12.2 million bales, about equal to last year at this time. Given that three months still remain in the marketing year, the USDA could raise its estimate once again in the May 12 monthly situation report. A conservative approach is more likely, though, because weekly shipments need to average roughly 290,000 bales per week to meet the current 12.5-million-bale target. Average shipments over the past four weeks have been only 260,000 bales.

On May 12 the USDA will release its first look at the 2009-10 global balance sheet. Preliminary forecasts show that among exporting countries, only India is expecting higher output of about 2 million bales. The USDA attaché report says that acreage in Uzbekistan – the second largest exporter after the US – will fall. Brazilian acreage is expected to drop 12%.

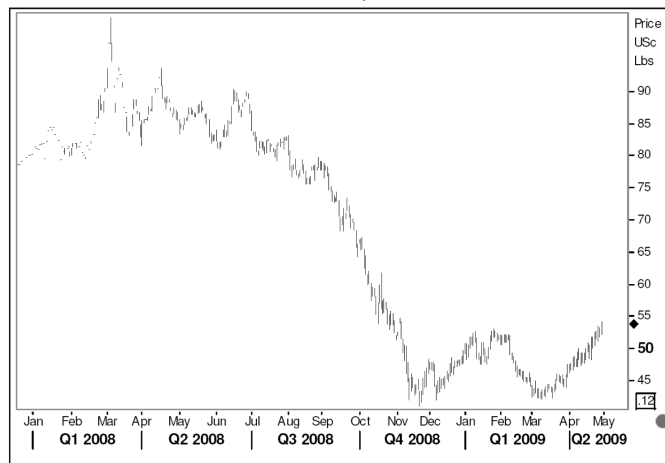
The March 31 planting intentions report estimates US acreage at 8.8 million acres, down from 9.47 million acres planted for the 2008-09 crop.

The cotton market is ill prepared for improved demand. The current balance sheet for 2008-09 shows ending stocks at 58% of consumption, which is big, but will be irrelevant soon enough. As more new-crop supply and demand statistics become available, we expect estimates for the 2009-10 balance sheet to show much lower inventory levels. The stage is set for cotton to become the paradigm for under-produced commodities.

Remain long.

[April 29, 2009]

Chart 8 – July cotton



Courtesy Reuters

COPPER

Recession...what recession?

Copper prices peaked at over \$4.20 per pound last summer, and when the realities of the economic woes to come surfaced the market plunged into a steep freefall that brought prices all the way down to below \$1.30 per pound. We now find the market back above the \$2-per-pound level. It is easiest to explain away the bounce as a mere correction to an oversold condition, but we believe that it is more complicated than that.

Chart 9 shows the path of copper prices tracking the DJIA quite closely. Economic data indicate that the economy is still contracting, but the stock market sees a bottom in sight. Perhaps the copper market is as forward looking as the equities market. Without much in the way of apparent bullish fundamentals in either the broader economy or specific corporations, the DJIA has rallied 23% off its early-March low. A closer look at some of the particulars of the copper market, on the other hand, show that there are bullish developments.

The prices of many of the commodities that we follow have not retreated to the levels that they traded at before the big bull markets of 2007 and 2008, even though their fundamentals no longer seem to warrant their current prices. In some cases, the drop in the cost of inputs has been slow to filter through to the producer, leaving a high cost of production and explaining why prices have lingered. Once the market finds a price at which output will increase, the bear markets will resume.

Not so in the case of copper. Production costs have come down, and are still falling, mainly because most mines receive enough credits from by-product production. We are trading light years above the cost of production. For example, updating the figures we presented in our March 2 issue, Freeport-McMoran reported first-quarter cash costs of \$0.66 per pound, down from \$1.16 per pound for 2008. It expects costs for the year to average \$0.70 per pound. Mining companies could produce more and enjoy healthy profits, even while pressuring prices. So unlike other commodities, copper prices may be underpinned by genuine demand, even though that would

appear to be an almost preposterous suggestion at this time.

The International Copper Study Group reports that the global balance showed a surplus of 363,000 tonnes of refined copper in 2008. Early forecasts for 2009 call for surpluses in 2009 as well.

Chile produces about 35% of the world's copper. Output in 2008 was down 4.1% over 2007. Analysts are divided on their outlook for 2009 output, but none expect a significant rise. Estimates range from unchanged to a 1.3% increase. Even that seems optimistic, with the first quarter gone and average monthly production down 6%. ICSG figures show that output in other producing regions compensated, though, which explains why the global balance sheet is showing a surplus.

On the demand side, industrial production continues to fall in countries that are significant consumers of industrial commodities. While the Chinese and Indian growth rates have slowed as well, the economy in both countries continues to grow. A recent IMF forecast estimates Chinese and Indian GDP for 2009 at 6.5% and 4.5%, respectively. Chinese refined copper imports for March were at record levels for the second consecutive month.

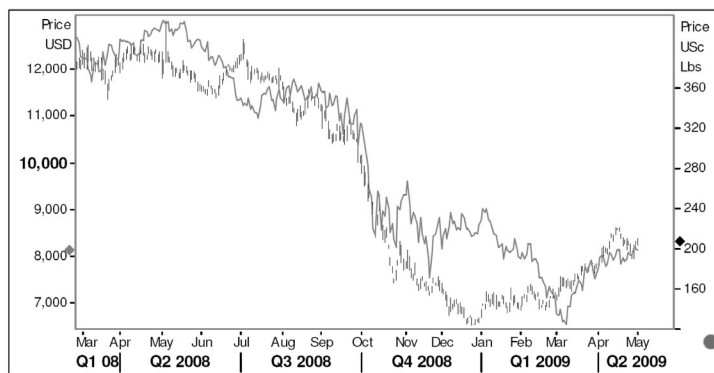
Although the global balance sheet shows no sign of tightness, global warehouse stocks have fallen by about 150,000 since early March (Chart 10).

Open interest has ballooned (Chart 11), but funds have been on the wrong side of this market and are just now chipping away at their net-short position (Chart 12), leading us to believe that the rally was strong-handed commercial sector buying.

On March 2 we presented a budding bullish case, but expressed fear of holding a long position in an industrial commodity during a recession. July copper settled at 152.65 that day. Hopefully, we at least kept you from being short. Use setbacks to establish a conservative long position.

[May 1, 2009]

Chart 9 – Nearest contract copper (bar), DJIA (line)



Courtesy Reuters

Chart 10 – Global warehouse stocks

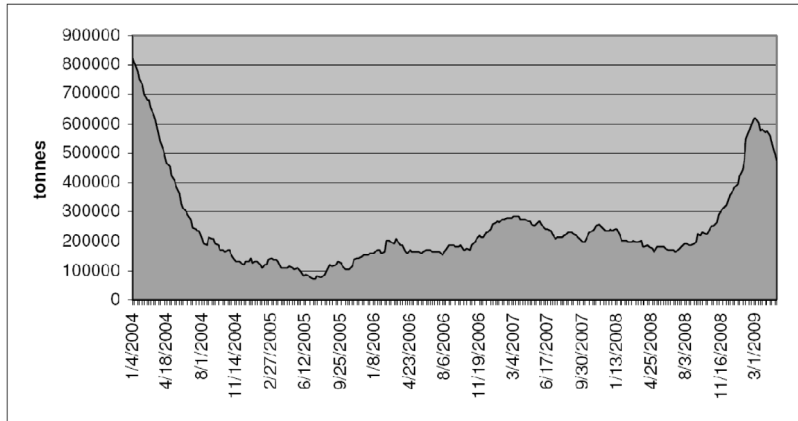
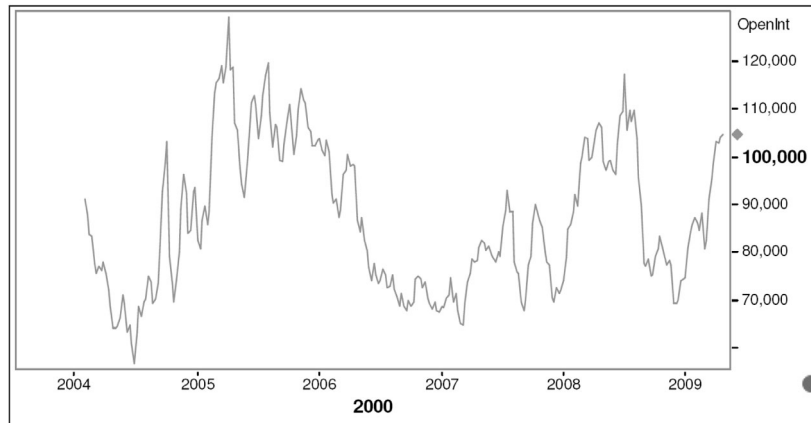
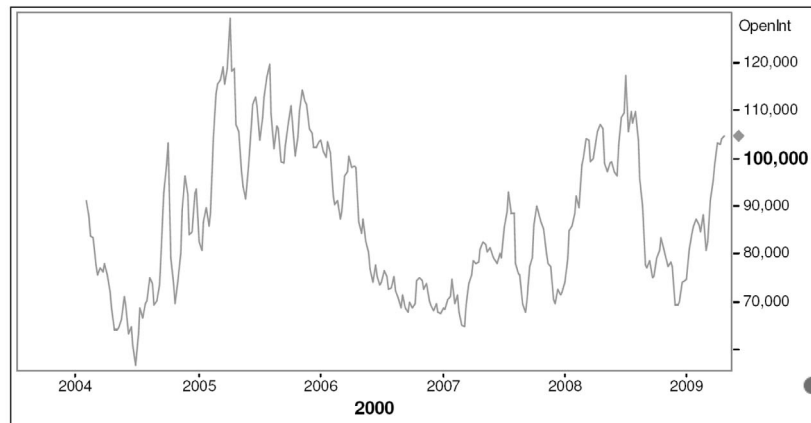


Chart 11 – Copper open interest



Courtesy Reuters

Chart 12 – Commodity fund net position



Courtesy Reuters

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