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Soybeans: beware of the deluge

Soybean prices have poked through the high of the recent range (Chart 1). There are several legitimate – but short-term – reasons for the rally.

The harvest in Brazil is almost complete and more than half way through in Argentina. Labor strife in Argentina, a trade dispute between China and Argentina over soybean oil, and general fears of slow movement of exports, however, have all contributed to keeping prices from responding to what we believe to be a long-term bearish fundamental environment.

Furthermore, the April USDA crop report confirmed that, indeed, the US 2009-10 balance sheet remains tight. Heading into the report, analysts believed that the estimate for ending stocks would rise by 18 million bushels, to 208 million bushels. Weekly exports had been slipping, and the domestic crush numbers pulled back after several months of very strong data.

With bumper crops being harvested in Brazil and Argentina, Asian buying would soon shift away from the US, and cancellations would appear. But the USDA left the estimate unchanged, at 190 million bushels, or 5.8% of consumption. That's an improvement over last season's 4.5% of usage, but still painfully low. At mid-decade, US ending stocks were averaging over 15% of usage.

The rules of the game have changed dramatically, though. Historically, the size of the US carryover was crucial, because the US was the world's largest grower and exporter. South American supplies could be counted on to supplement US exports. In years in which the US old-crop was tight, traders would worry about the gap between the time we were close to running out of beans in the US and the completion of the harvest in South America. Every blip in US Midwest weather throughout the planting, growing, and harvest season was scrutinized.

South American crops, however, have been getting bigger each year, and concerns over bridging the gap should fade accordingly. The April USDA crop report increased the estimates for both Brazilian and Argentinean harvests from the previous month's forecasts. Brazilian output is now expected at 67.5 million tonnes, up 500,000 tonnes from the March estimate, while Argentinean production will jump by 1 million tonnes, to 54 million tonnes. Chart 2 shows how the combined crops of the two countries have reduced the significance of the US crop.

The 2010-11 US crop now being planted is expected to be a record. March 31 planting intentions showed that soybeans will be planted on 78.1 million acres, up from 77.5 million acres last season. The sheer volume of beans available now from South America and from the new US crop to be harvested in the fall leaves a considerable amount of leeway for a bit of imperfect weather, as well as a continuation of strong demand from overseas importers.

The US balance sheet may be on shaky ground, but the USDA's April revisions inflated global ending stocks to 62.96 million tonnes, or a record 26.7% of consumption, up from the March estimate of 25.7%, and puts the carryover in a different league altogether from last year's 19.27%.

In the February 24 issue of *Focus on Futures* we recommended using a $9.85-per-bushel stop close only, basis May. Well, we're on the doorstep, and if we get a strong close above that level, we advise honoring that stop. Nevertheless, we are convinced of the bearish case, and we also encourage reentering the short side if the breakout of the range appears to be false.

Any new short positions should be in new-crop months – November and onward. Old crop prices may remain strong – or at least stronger than the new crop – through the end of the marketing year. *[April 21, 2010]*

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

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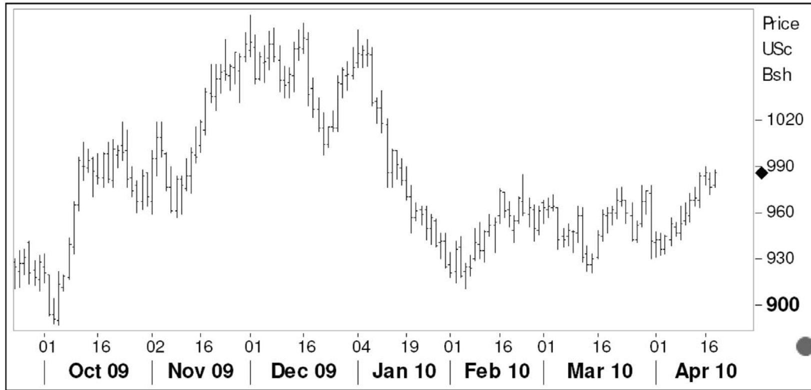
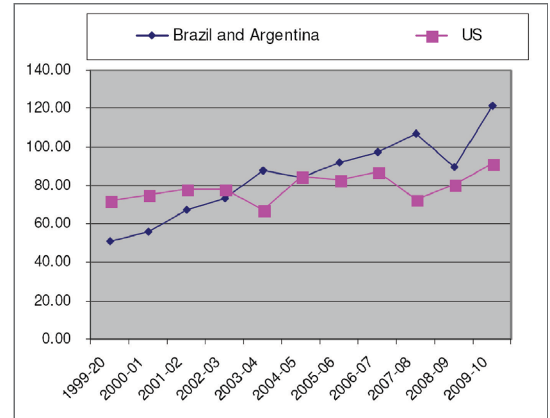
Chart 1 – May soybeans



Courtesy Reuters

Chart 2 – South American vs. US soybean production



SUGAR

Has the bear arrived?

Inasmuch as sugar was overpriced at 30¢ per pound – as it turned out – could it now possibly have become undervalued after its recent drubbing?

A blast of bullish news coincided with the top in sugar (Chart 3). But estimates for a mammoth 15-million-tonne global deficit for 2009-10 proved to be premature, primarily because of a late surge in Indian yields in some key regions. Indian output, which was forecast to be as low as 14 million tonnes at one point, will actually be closer to 18 million tonnes.

Another bearish factor that contributed to break the back of the market was an artificial drop in Indian consumption. The government rationed supplies to commercial users by restricting them to hold no more than 10 days' worth of supply.

Then, the outlook for the future shut the door on the bull run. Two years of below-normal monsoons singlehandedly drove prices skyward. Early forecasts are calling for a normal June-to-September monsoon season, which is vital for a 2010-11 Indian production recovery. If acreage bounces back to the pre-drought years and the weather is perfect, production could be as high as 30 million tonnes. But most estimates thus far have been between 22 and 24 million tonnes.

Measures taken by the Indian government to stabilize prices and ensure adequate supplies for the 2009-10 marketing year are probably no longer necessary. Analysts expect the government to halt duty-free imports and to remove inventory-level restrictions on commercial users.

However, 2009-10 carryover stocks are estimated at about 3.5 million tonnes, well below the comfortable pre-drought level of about 10 million tonnes. Sugar consumption in the country with the world's second largest populace continues to edge up. A USDA attaché report puts 2010-11 usage at a record 24.5 million tonnes, up from 23.5 million tonnes in 2009-10. So it's pretty clear that even if output comes in at the high end of the range of current estimates, Indian inventories cannot be replenished to pre-drought levels without imports. If growing conditions are not absolutely flawless and consumption estimates are accurate, we will actually be drawing down Indian stockpiles – rather than rebuilding – in the 2010-11 marketing year.

Although farmers in every producing nation have responded to the incentive of high prices and planted lots of sugar, the global supply situation remains vulnerable.

Another example is China. Consumption estimates vary – between 14 and 15 million tonnes – but demand has grown steadily. The drought-plagued 2009-10 harvest was dismal, with recent estimates as low as 10.6 million tonnes, down from 13.3 million tonnes in 2008-09. The government has been releasing state reserves at a much-faster-than-normal pace. Forecasts for the new crop are calling for a bounce to 14 million tonnes. China has imported 1 million tonnes per annum in recent years. With a 3.5-million-tonne production/consumption deficit, it's hard to see the Chinese not turning to imports, sooner or later.

Brazil is expected to dazzle the market with a 40-million-tonne crop, up from 36 million tonnes in 2009-10. It's not quite as dazzling as it appears on the surface, though. In 2009-10 the average ethanol-to-sugar ratio was about 58-to-42. This season – at least in the early going, when sucrose yields tend to be lower – that ratio is 62-to-38. That would be a record, or at least very close to a record, for the portion of the cane crop devoted to ethanol. The crash of sugar prices in an environment of skyrocketing energy prices has made ethanol production more profitable. With the dip below 15¢ per pound, sugar prices are now below production costs. Hardly the incentive needed to crank up sugar production.

After accounting for recent developments, the 2009-10 global deficit has moved from a 15-million-tonne deficit to a shortfall in the 7-million-tonne to 9-million-tonne range.

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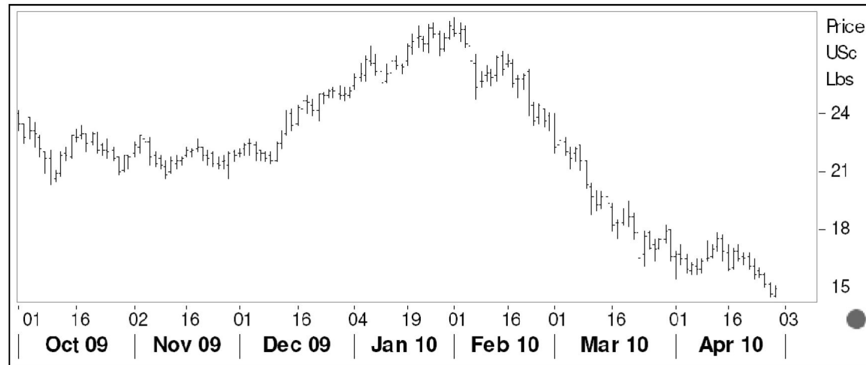
Assuming no crop failures, 2010-11 will probably show a balanced market.

Russia, Pakistan, Mexico, China, and the US will continue to be bigger importers than they have been in the past, tapping into the pool of sugar available for world trade, which ultimately determines the world price. And India is not out of trouble for certain either, as illustrated above.

We believe that heavy fund liquidation exacerbated the selling of a market whose fundamentals are not as bullish as they were, but are basically still bullish. Open interest has fallen by over 200,000 contracts, to 648,000 contracts, since the market peaked (Chart 4). Commitment of Trader data show that the commodity fund net-long position has dropped by 92,000 contracts (Chart 5), which, naturally, means that commercials have been buyers.

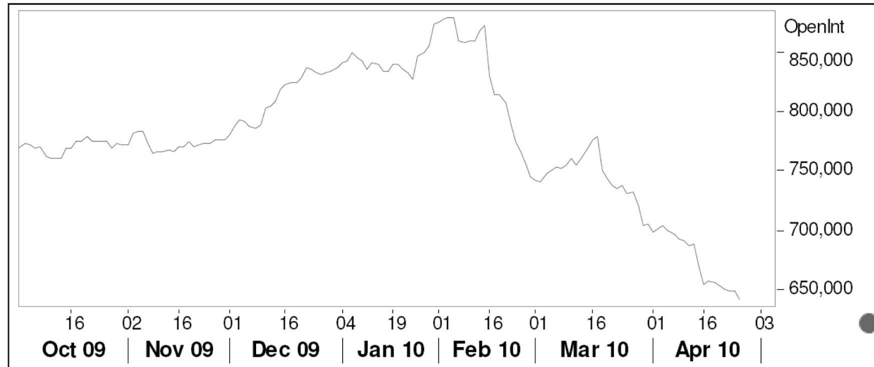
It's almost embarrassing to recommend a bullish strategy for sugar. No self-respecting technical analyst would admit to owning a long position in sugar at present, but we are not of that ilk. The market has now indeed become undervalued. Nibble at the long side. *[April 29, 2010]*

Chart 3 – May sugar



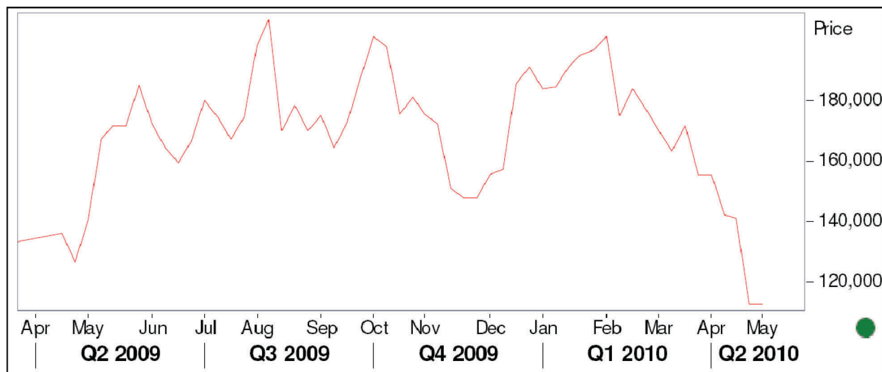
Courtesy Reuters

Chart 4 – Open interest



Courtesy Reuters

Chart 5 – Commodity fund net-long position



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COCOA

A growing deficit

Cocoa prices have sprinted to three-month highs as a result of a string of bullish developments – on both the supply and demand sides.

Ivory Coast arrivals continue to disappoint. The 2009-10 crop was expected to bounce back from the dismal 2008-09 harvest of 1.22 million tonnes, which was down from 2007-08 output of 1.4 million tonnes. The current season looked promising at the outset, with arrivals sharply out in front of 2008-09. For a good part of the main-crop campaign, arrivals were running about 15% ahead of the previous year's pace. Towards the end of the main crop, however, arrivals began to dwindle. The main-crop season has ended, and we are into the mid-crop harvest. As of the most recent reading, arrivals stood at 911,754 tonnes, down from 945,814 tonnes last year at this time.

Weather for the mid-crop has been favorable, and most local industry observers have confidence that yields will be high. However, there is little evidence to support this at present. Since the beginning of March, when the mid-crop began, average weekly arrivals have been about 6,000 tonnes, compared with about 16,000 tonnes last year.

There is historical precedent for a sharp recovery in the late going. An additional 300,000 tonnes of beans, which would bring the total mid-crop close to the record set in 2007-08, would still leave total output at about last year's level.

There's not been much assistance from the other West African producing nations. Not that Cameroonian production would have made much of a difference, but even its harvest seems to be about 5% below expectations for a crop of 205,000 tonnes.

Ghanian output is now estimated at 650,000 tonnes, about 50,000 tonnes below earlier estimates. Local officials claim that the harvest is actually higher, but that there is significant smuggling across the border into the Ivory Coast, where prices paid to farmers are higher. If so, those beans should be inflating Ivorian arrivals, but as illustrated clearly above, that is not what we're seeing.

The bullish case has now been solidified from the demand side. The first-quarter European grind, reported in mid-April, was up 8.1% and was initially greeted with apathy. The market actually sold off after the data were released, because they were in line with expectations. But the North American grind came in above estimates, at 16.2%, and that sparked a $300-per-tonne rally.

These excellent results are especially significant, because grinding capacity in origin countries has been growing, and it's long been assumed that we're not going to see any growth in grinding activity in importing countries.

The most recent estimates for the 2009-10 balance sheet show a deficit of just over 100,000 tonnes. These estimates have been calculated using a 2.5% growth rate for grindings and the assumption of larger West African crops. We can safely lop 100,000 tonnes off ending stocks to account for these changes in the market. A 5% grinding-growth rate and just 50,000 tonnes less production would represent a global deficit of approximately 250,000 tonnes

Open interest has been rising, but is still modest by historical norms (Chart 7). Commodity funds have obviously taken notice, but their net-long position of 31,000 contracts is relatively small (Chart 8), leaving substantial buying power waiting on the sidelines.

We continue to recommend maintaining manageable long positions that allow for the huge swings this market is noted for. Over the coming months, look for prices to exceed the $3,500-per-tonne high set late last year. *[May 3, 2010]*

Chart 6 – July cocoa

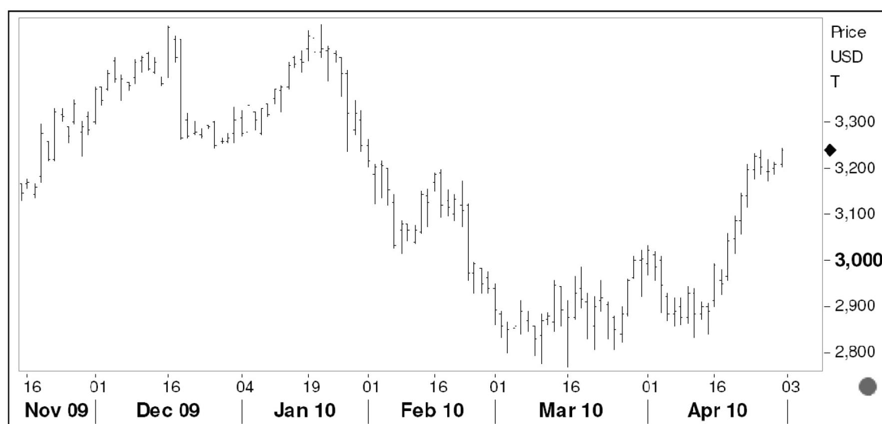

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Chart 7 – Open interest

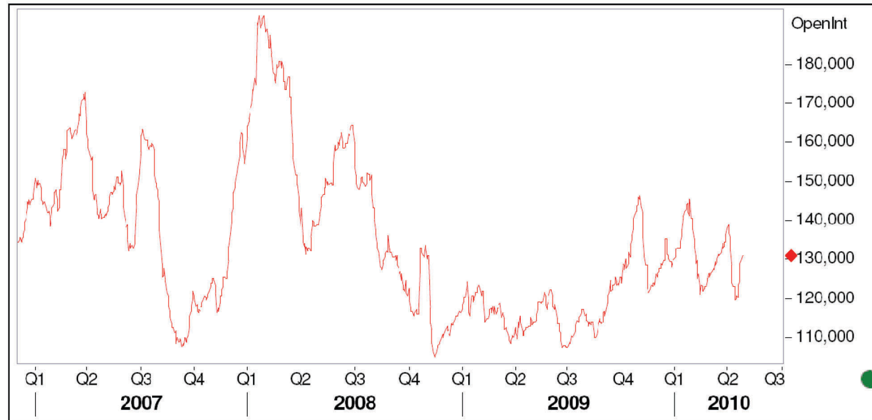

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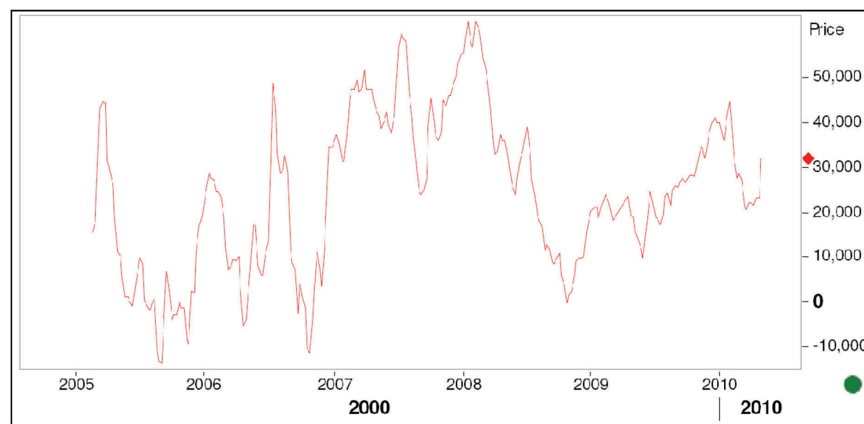
Chart 8 – Commodity fund net-long position



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COTTON

Indian ban on cotton exports tightens market further

Cotton inventories in India have been tightening in recent months, and the textile industry has been pressuring the government to ban exports to ensure that mills have sufficient supplies. On March 10, the textile ministry assured Parliament that there were ample inventories to meet both domestic mill usage needs as well as exports, and as a result, there were no plans in the works to ban cotton exports.

On April 9 the government announced a small export tax, but the market reaction was muted. On April 19 a full-fledged export ban was imposed, and this time July cotton took off and closed up the 3¢-per-pound daily trading limit. The export ban and the market's reaction underscores the tight conditions for the global cotton market.

The textile industries in China, Pakistan, and Bangladesh are the hardest hit, because they rely heavily on Indian exports to meet their cotton requirements.

Pakistan produces closes to 10 million bales, but imports an additional 2 million bales per year, and its import needs are greatest in the May-through-July period, when its old crop has been depleted and new crop supplies will not be available until late July.

Bangladesh imports just about all of the 4 million bales required to feed its mills, 30% of which it buys from India.

China imported 1.2 million bales from India in January and February and has contracted to buy more. India was expected to move out in front of the US as China's largest supplier of foreign cotton, but the export ban will put the US back on top, at least for now.

Contracts signed before the ban was announced will be honored, but there does not seem to be much cotton that falls into that category. Press reports claim that Bangladesh has already run out of cotton. In Pakistan there are reportedly

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only several days' worth of supply left country-wide, and mills will have to close if alternative sources are not found.

Looking ahead to the 2010-11 crop year for the largest producing nations, some are taking advantage of high prices. In the US, the March 31 intentions report showed that planted cotton area will jump by 1.35 million acres, or 15%, over 2009-10 area, to 10.5 million acres.

Indian area is expected to increase by about 9%, while Pakistani farmers ramp up output by 10%. Only Chinese cotton area is anticipated to slip by about 2%, mainly because farmers are attracted to federal government subsidies for wheat that are not available for cotton.

Despite the promise of larger crops come fall, not a single bale of the new and larger crops will be available for many months. The April USDA crop report showed that the global balance sheet has tightened further. Ending stocks for 2009-10 are now forecast at 50.91 million bales, or 43.9% of usage, down from the prior month's 44.4% and in a different league from the bear-market 57% of usage at the end 2008-09. This will now be the lowest global carryout since the end of the 1994-95 season.

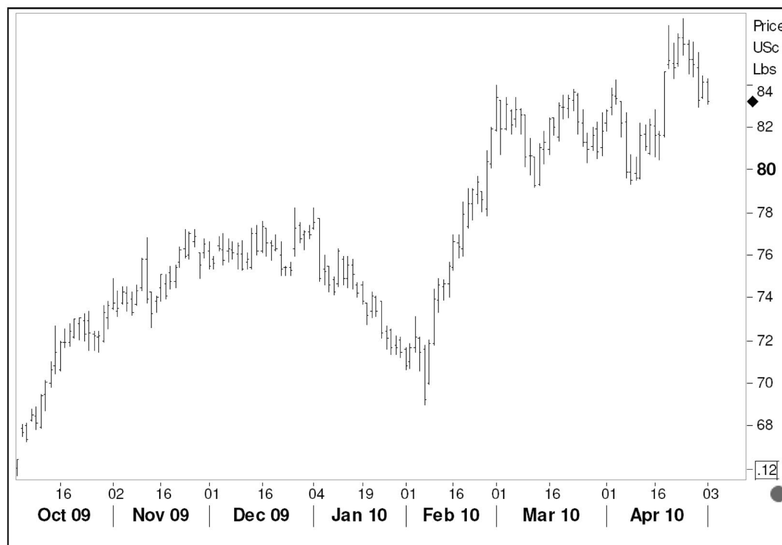
March mill usage in the US was 312,000 bales, the highest monthly total since June 2009 and well above average monthly usage over the past year of about 260,000 bales. Perhaps it is the beginning of a recovery in domestic demand.

The main item to watch for in the coming weeks is Chinese purchases of US cotton. Although US exports have fared better than expected early this year, China has purchased less than it has in recent years, because as mentioned earlier, it has been buying from India. Now that Indian exports are closed, at least for the balance of the marketing year, there is little doubt that China will be short. The Chinese production/consumption deficit was larger this year, because of its poor crop. The shortfall was 16 million bales, compared with 7.3 million bales in 2008-09 and 14 million bales in 2007-08.

Remain long and feel comfortable adding to long positions, but use a 79-cent-per-pound stop close, basis July.

[May 4, 2010]

Chart 9 – July cotton



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Subscription Enquiries for
Friedberg's Focus on Futures
Suite 250
181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
416-364-1171

All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group Ltd.
Suite 250
181 Bay Street
Toronto, Ontario M5J 2T3
416-350-2903
Attn: Sholom Sanik

For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250
181 Bay Street
Toronto, Ontario, Canada M5J 2T3
1-800-461-2700

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